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INTERNATIONAL COMPETITIVE EFFECTS OF THE HIGH VALUE OF THE DOLLAR

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

THE CAUSES AND EFFECTS OF THE CUMULATIVE APPRECIATION OF THE DOLLAR AGAINST THE CURRENCIES OF OTHER MAJOR INDUSTRIAL NATIONS

JUNE 6 AND 14, 1984

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INTERNATIONAL COMPETITIVE EFFECTS OF THE HIGH VALUE OF THE DOLLAR

WEDNESDAY, JUNE 6, 1984

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,

Washington, DC.

The subcommittee met at 9:35 a.m., in room SD-538, Dirksen Senate Office Building, Senator John Heinz (chairman of the subcommittee) presiding.

Present: Senators Heinz, Gorton, Proxmire, and Riegle.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. The subcommittee will begin 2 days of hearings on the key trade issue of today, the effect of the high value of the dollar on America's trade competitiveness.

We are indeed very fortunate to have such a distinguished list of witnesses to comment on the question. The Chairman of the Federal Reserve Board, Paul Volcker, will testify next week. Today we have Dr. Martin Feldstein, Chairman of the President's Council of Economic Advisers, and also Deputy Secretary of the Treasury Tim McNamar; and following our official witnesses a distinguished panel of experts will provide their unique perspective.

Some would argue, I suppose, that the current high value of the dollar is a reflection of the success of the current administration's economic policies. The challenge facing the President when he took office was to reinvigorate the private sector and to revitalize the domestic economy by restoring noninflationary growth. The underlying assumption was that since U.S. inflationary policies had aggravated international problems, the best thing that we could do would be to set our house back in economic order. Our Nation is now reaping the benefits of that policy decision: Inflation is under control; vigorous growth has been restored; many sectors of our economy, with notable exceptions such as steel, are benefiting.

It has, however, become apparent that it is necessary to turn our attention to the international economic agenda as well, because it is there—particularly with regard to the value of the dollar and the trade deficit it exacerbates—that the greatest danger lies.

Concern over the value of the dollar has moved from the financial section of our Nation's newspapers to the front pages recently. Why? Because trade no longer is an esoteric issue discussed only by intellectuals and Government bureaucrats. Trade has more than doubled in importance to our economy over the past decade. Now

that 1 out of every 5 manufacturing jobs and 2 out of 5 farm acres depend on exports for their existence, the value of the dollar becomes a vital interest to more than just intellectuals, bureaucrats, and tourists.

Above all, as we are painfully aware, there is the growing threat that this Nation is heading for a dubious record in the category of trade deficits. Current estimates predict a trade deficit in the range of $100–$120 billion this year, doubling last year's record shortfall, which was double the previous year, also a record. Indeed, last month's $12 billion trade deficit was six times greater than the monthly trade deficit just 3 years ago.

As we increasingly go to the international credit markets to finance both our foreign trade and our domestic budget deficits we find ourselves in the peculiar position—the world's largest and richest economy—of moving from the status, of being a net creditor to that of a net debtor to the rest of the world. If present trends continue this will happen just 2 years down the road and then we can join Mexico, Brazil, Argentina, and all the other debt troubled countries in the same category.

Despite the growing deficit and our movement to debtor status, the dollar has reached new highs this year and has shown remarkable resiliency in retaining its value. According to conservative estimates the dollar is so overvalued that it is just as if we had levied a 25-percent tax and a resultant 25-percent price increase on every American export, every bushel of wheat or bucket of bolts, all because of our overly strong currency. Similarly, the overvaluation of the dollar has provided a subsidy of up to 25 percent on all imports, be it foreign steel, foreign automobiles, or other foreign products imported to our shores.

Although statistics show that thus far many sectors of our economy have escaped damage from our overvalued currency, clearly many other important sectors, particularly our basic and capital goods industries, have been significantly damaged by the additional burden imposed by the overly strong dollar.

And so I would seek and be most interested in the comments of our witnesses as to what the future has in store for these critical industries, and even for our high-tech industries as well, if the dollar is not brought back into line with our underlying competitiveness within the next year.

The key questions before our witnesses today are: To what extent and why is the dollar overvalued? What are the consequences today and in the future? What can and should we do about it?

I am very eager to hear what our witnesses have to say and I am delighted to welcome to our committee Martin Feldstein who has, I think, brought to Washington a great intellect, a tremendous intellectual honesty, and a willingness to say what needs to be said even if not everybody enjoys hearing it all the time.

Dr. Feldstein, we welcome you. Please proceed.

STATEMENT OF MARTIN S. FELDSTEIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Dr. FELDSTEIN. Thank you very much. I am pleased to be here at what I expect will be the last hearing that I participate in in my official capacity.

OIL CRISIS PRECIPITATED TRADE DEFICITS

Certainly the subject of this set of hearings is one of the most serious and also one of the most complex questions facing us here in Washington. One reason why it is so complex is that for the United States it's a new experience. We didn't have any trade deficits to speak of until the mid-1970's when the rise in the price of oil put us on a course where we had roughly $25 or $30 billion a year trade deficits that we could finance with the earnings that we had on foreign assets. But now in the last few years, as your introductory remarks indicated, that has all changed and we are suddenly facing much, much larger trade deficits.

I think the record $12.2 billion announced for the recent month puts us on a course where we are likely to see $120 billion of merchandise trade deficits by the end of this year. Exports have been deteriorating; imports have been rising very rapidly; and that's why our trade deficit represents about 3 percent of our GNP. Moreover, at this point, I think, looking ahead to 1985, we can pretty well say that 1985 will again be a year of very large trade deficits, almost certainly in the triple-digit range, above $100 billion.

Why do we have these deficits? Well, primarily it is, as you indicated, because of the rise in the real value of the dollar, which has increased about 45 percent relative to an average of the currencies of other industrial countries in the past few years. We think that represents about two-thirds of the reason for the deterioration of our nonoil trade balance since 1981, about two-thirds. The rest can be attributed to a combination of two things: First, a shrinking of imports by the debtor nations, primarily in Latin America, but also elsewhere, and second, the relative pace of the recovery in the United States and in the other industrial countries of the world.

But those two factors, the shrinking imports by the debtors and the stronger recovery in the United States than in Europe, are not independent of the strength of the dollar. The very strong dollar has increased the real value of the liabilities of the debtor nations and contributed to their very serious problem in meeting their international obligations. So part of what we would describe as due to the problem of shrinking imports by the debtor countries is in reality due to the strength of the dollar.

Now, why has the dollar risen so much? The key clearly is to think about the dollar not as a short-term balancer of imports and exports. It obviously isn't doing that. Rather it is important to think of the dollar as an investment asset, as an asset similar to stocks and bonds in the portfolios of international investors both here and abroad. The dollar has become more attractive because the expected real return on dollar securities has gone up, and it has become more attractive because the risk of investing in dollars has appeared to decline. And so with a higher expected return and lower risk it is not surprising that foreigners want to move their

capital to this country and that Americans are more eager to invest here than to put their funds abroad.

Now I think this improvement in return and in risk can be divided into two phases.

The first of these, going back to 1981, was associated with the change in monetary policy and with expected inflation. With the clear perception that the Fed had shifted monetary policy and that we were now seriously pursuing an anti-inflationary monetary policy, real-interest rates rose and the risks associated with runaway inflation that we were facing in 1980 and 1979 began to abate. For both of those reasons, the higher return and the lower uncertainty of inflation, the dollar securities became a better investment, a more attractive investment.

FEDERAL BUDGET'S EFFECT ON INTEREST RATES

But now we are in what I would call a second phase of the problem in which, while we continue to benefit from sound monetary policy, the primary reason for the very high real return on dollar assets has been the increase in the deficit in the Federal budget. That deficit absorbs substantial savings and inevitably raises real-interest rates. Last year borrowing by the Federal Government absorbed three-quarters of the private savings generated in the United States, including the savings of households, of businesses, of pension funds, State and local governments; three-quarters of that was borrowed back by the Federal Government, leaving us with a net saving rate of only 1.9 percent of GNP, about a third of what we are accustomed to. And so inevitably interest rates rose. Those higher real-interest rates attracted capital from the rest of the world, and last year we had a capital inflow of $38 billion. This year we expect a capital inflow of $80 billion, perhaps $90 billion. That will finance more than half of all net fixed investments in the United States; it will finance about 40 percent of the amount of our budget deficit here.

But to get that capital inflow we have to have a trade deficit, and so the attractiveness of investing in the United States pushes up the value of the dollar and gives us the trade deficits that we have seen.

Now I think that relationship between the trade deficit and the capital inflow is important, because it reminds us that although the trade deficit is a terrible thing, doing very substantial damage to key American industries, the capital inflow that goes with it actually performs a useful role. It's a kind of safety valve. Without it we would have much less capital in the United States, our net fixed investment this year would be roughly at half the level that it is otherwise going to be, and interest rates would be a great deal higher.

So in effect what are seeing is a spreading of pain, a spreading of the adverse consequences of our large budget deficits, a sharing of it between the domestic interest-sensitive sectors like housing, plant, and equipment spending, a sharing of it between those and the import and export part of the American economy. The real problem, then, is underlying budget deficits and not the trade deficits.

I am not trying to minimize the seriousness of the merchandise trade deficit in saying that the capital inflow has favorable effects. It is clear that a trade deficit of 3 percent of GNP concentrated in a relatively small part of our overall industry is doing substantial damage. Moreover, over the long term we are accumulating debt at a rapid rate. We are, as you said in your introduction, Senator, eroding the overseas investments that we have built up over decades, and so we will soon inevitably become a long-term debtor to the rest of the world, and that, in the future, will require us to give up more and more of our product to export to other countries to pay the net interest that we owe on that.

It is not quite as bad, though, as you suggested when you compared our situation with Mexico or Brazil, because while Mexico and Brazil owe dollars, not pesos, we owe our own currency so that we don't have the same problems of repayment that they do.

What should be done about all this? Obviously we don't want to go back to higher inflation or more uncertain inflation in order to make the dollar less attractive, and we don't want to slow down our recovery in order to improve our trade balance. I think we know that direct intervention in the foreign exchange market is not a way of offsetting these fundamental problems.

Therefore, although there are many causes of the problem that we face, there is only one course of action that commends itself to us, and that is to reduce the deficits in the Federal budget. That would give us lower real-interest rates, it would give us a more competitive dollar, and then with a lag it would give us improved net exports.

I think the timing in all this is very important. I think it is important that the reductions in the budget deficit occur in a predicable way with sufficient time lag. In your opening remarks you wondered what might be done to bring the dollar back substantially within the next year. Well, I would hope that the dollar would come back at only a moderate rate, because it is very important that we avoid a sharp fall in the dollar until we are beginning to see substantial progress in reducing budget deficits.

If the dollar were to fall sharply right now that would inevitably mean higher prices in this country; it would mean much higher interest rates, because we couldn't count on the capital inflow that I referred to a few moments ago. Therefore it is important that the reduced capital inflow associated with the trade deficit be offset by reduced Government borrowing as we begin to shrink the deficits in the Federal budget.

DOWNPAYMENT PACKAGE A SIGNIFICANT BEGINNING

I am quite optimistic that the downpayment package that you here in the Senate and that the House has been considering is going to get enacted. I think that it is a significant start. I think it does represent very substantial progress for this year. But obviously more needs to be done in 1985 if we are really to shrink these deficits in the future.

If we don't make any more progress in dealing with the deficit, any more progress than the downpayment package, what will happen to the dollar and to trade? Well, eventually the dollar will

fall. It will fall regardless of whether or not we make progress in dealing with budget deficits and interest rates, because after a certain point the rest of the world is just not going to be willing to hold more dollar securities even at higher and higher real rates of interest. Eventually, therefore, the current account will move back into balance and our trade deficit will turn into trade balance or even a trade surplus.

But that will carry with it terrible side effects for our domestic economy if we have not at the same time reduced the budget deficits. It will carry with it terrible side effects because real-interest rates will be pushed up sharply in this process. That is why it is so important that we have a balance of reduction in our trade deficit and in our budget deficit here at home along parallel paths into the future.

Let me just conclude by saying that I think we are getting off to a good start in doing that by the downpayment package. We can move to an orderly transition, but what gets done in the next few weeks in passing that and the commitment to follow up next year are really crucial.

Senator HEINZ. Dr. Feldstein, thank you very much for a very concise summary of the situation. To make sure that I understand how you view the equilibrium that we would ultimately come into, you are clearly not saying eventually the dollar will fall, things will be in equilibrium and don't worry about it. You are saying that will happen, but if we do nothing to reduce the Government deficit we have a lot to worry about.

Dr. FELDSTEIN. Exactly right. The trade problem will take care of itself eventually. Eventually may be a long time. A lot of American industry may have suffered terribly along the route. We may come back at a lower level of exports and imports, but eventually we are going to get a balance there. But if we don't have the budget deficits down at the same time that balance is going to imply much higher interest rates, lower capital accumulation, less housing, much more crowding out in domestic markets here in the United States.

Senator HEINZ. How high would those interest rates be, for example, if we bumped along with the kind of budget deficits we would have—assuming passage of the downpayment on the deficit—therefore deficits in the $180 billion or so range for the next 5 or 6 years? What kind of interest rates might we expect?

Dr. FELDSTEIN. I can't really give you a precise number. I think, though, it just helps to recognize that what we are talking about is that if the capital inflow were to dry up, if we were to go back to a trade balance and yet continue to have those kinds of deficits, there would be virtually no savings available for private investment in the United States. That just means that interest rates would be very high in order to ration off demand. The interest rates per se are less interesting than the fact that our housing stock would stop growing, our capital per worker would cease to increase.

Senator HEINZ. To many people those problems may seem like somebody else's problems, because that is not this year, may not even be next year, and once you get beyond 30 seconds in a television commercial these days people seem to lose interest in what is

happening tomorrow let alone 2 years from now. So let's focus on what is happening now.

We have mentioned that there is a growing trade defict to the tune of $120 billion, and the farmers understand what that means to them because they are not making any money. The dollar denominated price of their products, their feed grains, is so low that they understand what that means. My steelworkers in Pittsburgh who are still laid off know what it means. Not just because of the imports, but because it is not profitable given the low level of prices, partly because of subsidies and partly because of the weakness of other currencies relative to the dollar. They understand through their unemployment what the situation means. That part is obvious. What I would like to explore is what the meaning is for our capital goods industries.

Now some people say investment in industry is OK, and we are not paying any long-term price; if we can just straighten out that deficit next year we're OK; and we haven't paid any price and there is no problem. Do you agree with that analysis? Or are we paying something beyond the obvious low income of farmers and the obvious unemployment, painful, as it happens to be, of steelworkers and people in those kinds of industries? Are we paying some other prices here, or not?

Dr. FELDSTEIN. Certainly investment, the subject that you raised, is substantially lower now as a share of GNP than it has been in the past. Last year net fixed investment, including housing as well as plant and equipment, was 3 percent of GNP. This year it will be about 4 percent of GNP. Historically over the last several decades it has averaged about 7 percent of GNP. So we are not putting in place the kind of capital that gives us growth and productivity; we are not seeing the kinds of improvements in our housing stock that we have seen in the past.

NET INVESTMENT IS TWO-THIRDS BELOW NORMAL RATE

Senator HEINZ. I think that is an absolutely key point. In fact what you have just said is that net investment is running at about two-thirds below its normal rate in this country, and here we are in a period of economic expansion during which period capital goods are supposed to be accumulating, and people are supposed to be building capacity for expansion. We have an economic expansion without expansion. How do you explain that?

Dr. FELDSTEIN. I think the explanation is very simple. We have very high real-interest rates. To put it differently, the explanation is that the Government is borrowing, as I indicated, about three-quarters of all of the net savings being generated in the economy. If you are going to finance investments, you can only do it in one of two ways. Either you have to have net savings generated at home, or you have to import the funds from the rest of the world. We have been supplementing our very low rate of net domestic savings after Government borrowing. We have been supplementing that with a capital inflow from the rest of the world as a result of our trade deficits. So in a strange and roundabout way the trade deficit has been actually helping our rate of capital formation here in the United States.

Senator HEINZ. Getting back to net investment, as I understand it capital spending has been going up since the first half of 1983; capital spending is supposed to increase throughout this year; and it is going to help us for economic recovery. Now most of us who aren't trained economists would think that when capital spending is going up that means that net investment is probably going up, but as you point out, net investment is very low. How do you resolve that apparent contradiction?

Dr. FELDSTEIN. There are two distinctions to be made. One is that net investment is also rising. It's just low. It is coming up from a very deep hole. It has been coming up at a good rate in comparison to previous recoveries, but it is coming up from such a low hole that it is still at a level, in comparison to GNP, which is quite low by historic standards. There is a difference, though, between total capital spending and net investment. The primary difference is that one recognizes depreciation and the other doesn't. Gross investment, which is really another way of saying capital spending, is before making any provision for depreciation. Net investment is only a small fraction of it, because about two-thirds of all of our gross investment simply represents replacing the capital stock that is wearing out, and that fraction has been getting higher because we have been moving toward more and more short-lived equipment: vehicles, computer equipment, and other things that wear out a lot faster than a steel mill.

Senator HEINZ. That is an interesting point. Are we fully replacing the capital equipment that is wearing out?

Dr. FELDSTEIN. In the aggregate we are, we are fully replacing it, plus a bit. There may have been one quarter or two when the statisticians told us we were not. But basically the fact that net investment is positive means that we are fully replacing it, plus something.

Senator HEINZ. Plus a little bit. What I suppose that means is two things. No. 1, we are not building any substantial increases in capacity, which suggests that we are going to bottleneck ourselves in certain places, if not now, sometime in the future, with inflationary consequences.

Dr. FELDSTEIN. We do run a greater risk of that.

Senator HEINZ. And second, it suggests that when there is on average a replacement of all assets that some industries are doing a better job and some industries are doing a worse job. What characteristics, if any, do the industries that are doing a better job have and what are the characteristics of the ones that are not able to or are doing a worse job in terms of renewing themselves?

Dr. FELDSTEIN. Well, I would have to actually go and get you a more detailed analysis to give you a proper answer on that, but it is clear that some industries are growing very rapidly; the demand for their products is very high. All of the very high-technology computer-oriented industries are investing a great deal to keep up with output. All other industries, many of which are close to home for you, are not doing that kind of investment.

Senator HEINZ. So it is probably fair to say that industries that produce capital goods, or goods related to that—such as lathes, stamping machines, trucks, the equipment you need to run the basic industry of the country—that those are not in such good

shape, and that the high-tech computers of Silicon Valley are doing pretty well.

Dr. FELDSTEIN. My impression is trucks would be the one I would exclude from that list. But as they say, metal bending machinery, lathes, and other kinds of equipment like that have not been in great demand; trucks and other vehicles have been an important part of the growth of business investment.

Senator HEINZ. Then what you are describing to me sounds as if we are, with respect to the basic manufacturing, capital goods-intensive industries, deindustrializing America.

Dr. FELDSTEIN. Well, that probably is too strong.

Senator HEINZ. Put it in your words. We are only moderately deindustrializing America?

Dr. FELDSTEIN. No, it's growing. It's just not growing as fast as we would like.

Senator HEINZ. What we seem to have, as I understand what you said earlier, is a lot of investment in very short useful-lived investments. As far as I understand what those investments would be, they are not in basic manufacturing, capital goods, machine tools, lathes, or those kinds of industries. The industries that have short-lived investments are computers, microchips, the fairly high-tech end of the scale.

Dr. FELDSTEIN. Machine tools production has increased very substantially in the last year. I don't want to make it seem too extreme as we describe this situation.

Senator HEINZ. How would you characterize the difference between short-lived equipment and long-lived equipment in order to end the ambiguity in this conversation?

NEW PLANT GROWTH IS LAGGING

Dr. FELDSTEIN. I would say that plant, for example, actual construction of new plant has been lagging much more. That is the most long-lived equipment. When you get into some very heavy standard electrical and nonelectrical machinery you're talking about things that might last 10 to 15 years or even longer in normal use. That is what has been relatively depressed in comparison to vehicles, office equipment, numerically controlled machine tools, and others which focus on cost saving rather than output expansion.

Senator HEINZ. And as long as real-interest rates continue to stay at historic highs is that situation likely to continue?

Dr. FELDSTEIN. I think so, yes.

Senator HEINZ. And, therefore if we do not address the budget deficit not only will real-interest rates remain high, but we will run into an international currency wall at which point current investors in the dollar will say "I'm no longer quite as interested in investing in the dollar." The $80 billion that we expect and need this year from abroad will not be forthcoming, and, let alone nominal-interest rates, real-interest rates will go up some more. At that point I would assume that net investment would really be in trouble and that we would be deindustrializing America.

Dr. FELDSTEIN. Well, if we saw that $80 billion that you just referred to go away, if we didn't have that capital inflow, half of all

our net fixed investment would vanish this year. So it is a very serious problem.

Senator HEINZ. Does it worry you that the United States is becoming, necessary as it may be, but because it is necessary, a junkie for foreign borrowing? You've said we can't get along without it and the worst thing that could be is to suddenly stop cold turkey like the heroin addict. Are we a junkie for international borrowing now? Are we hooked?

Dr. FELDSTEIN. No, I wouldn't describe it that way. I really do think that in effect the foreign borrowing is making the best of a bad situation, that the bad situation is the shortage of domestically generated savings, and what we are doing is a normal thing to be doing in the market. But I think it tends to hide some of the adverse consequences, in terms of our own interest rates and domestic capital formation, of the large budget deficits.

Part of the crowding out is occurring in housing, plant, and equipment and part of it is occurring in our net exports, and eventually, as you say, we will run into a wall, or at least a steeply rising hill, in which we are not going to be able to get that kind of capital inflow, and then if we haven't remedied our domestic situation, if we haven't brought our budget deficit down, we will see much more crowding out of domestic plant and equipment spending.

Senator HEINZ. I want to yield to Senator Gorton in 30 seconds, but let me just rephrase my characterization if I did it too strongly.

We are not a junkie for foreign debt yet, but unless we get our budget deficit in order we will be hooked and a junkie in the sense that when somebody turns the spigot off we will have excruciating economic withdrawal pains because interest rates are going to soar out of sight. Would you agree with that?

Dr. FELDSTEIN. That's a nice analogy. I like that.

Senator HEINZ. Thank you. [Laughter.]

Senator Gorton.

Senator GORTON. Let me follow up, Dr. Feldstein, with just a couple of questions relating to the same subject you have discussed with the chairman.

You said in passing in your introductory argument that you felt that the downpayment which now seems fairly likely to be adopted by the Congress, with outer ranges, I gather, of $142–$182 billion, was adequate. Would you expand on that and what you think at least the short-term impact of such a downpayment would be? Because I don't remember or relate that to your advice to us in January and February of this year as to what you thought would be an adequate downpayment.

Dr. FELDSTEIN. I think there are two senses in which you can talk about the short-term impact. It is clear that the package does nothing for deficits in 1984; it does very, very little for deficits in 1985; it then begins to have a substantial impact in terms of the projected deficits in 1986 and 1987.

But since it does nothing in 1984 and 1985 to shrink the Government's demand for funds I think we are going to continue to see the pressure, the conflict between public and private borrowing, and therefore high short-term interest rates. But financial markets are forward looking, and they will, I hope, look at the likely impact

of this deficit reduction package on the Government's borrowing needs in 1986 and 1987, and I think if they understand the strong commitment that is involved in taking these steps this year to follow on next year that we could rather quickly see a topping off or a fall in medium- and long-term interest rates.

To just summarize, I don't think much is going to happen to short-term interest rates or immediate crowding out as a result of this package, but I think because it changes expectations about future borrowing by the Government it could have the favorable effect of causing medium- and long-term rates to come down within the months ahead.

NEXT CONGRESS NEEDS TO CONTINUE DEFICIT REDUCTION

Senator GORTON. Second, perhaps as your last official or semiofficial act in your present position, not foreshadowing what you may say to us in January or February of next year as an outside academic, tell us what you think is going to be required of the Congress beginning in 1985.

What we are dealing with now is, as has been quite properly characterized, a downpayment which assumes considerable annual payments thereafter. In addition to what this downpayment resolution will accomplish in 1986 and 1987, give us the parameters of what you think we must add in 1985 and perhaps a brief outline as to how you would feel that could most equitably and effectively be distributed.

Dr. FELDSTEIN. I think that to make a significant dent in the remaining deficits it would be necessary next spring to enact further deficit reductions for 1986 and 1987 of at least as large an amount as the ones that are contained in this package. This package has $50 billion of deficit reduction for 1986. I'd like to see that raised to $100 billion for 1986. For 1987 there is about $70 billion in this package. I'd like to see that raised to about $140 billion with corresponding changes in the outyears.

To use Senator Heinz' words, you can't withdraw from this problem too suddenly, because an economic body can't take the shock of a complete turnaround in the fiscal stimulus that this deficit provides. So we have to come down gradually. But it can't be too gradually. There has to be a clear indication to financial markets that the end is in sight, and there has to be enough relief of pressure to offset this crowding out as we move closer to full employment.

So I think roughly $100 billion in 1986, $140 billion in 1987 off deficits that we are projecting now would be the numbers that I would be aiming for, at least as I see the economic future from this point.

As far as the composition of the kinds of changes that are going to be necessary, I think I would rather wait on that until I'm a private witness before this committee.

Senator GORTON. Dr. Feldstein, I should like to thank you for your advice and counsel in your present position and tell you how much I have appreciated it, and how much I have gained from it, and express the hope that you will be back with us frequently in the future.

Dr. FELDSTEIN. Thank you very much.

Senator GORTON. Thank you, Mr. Chairman.

Senator HEINZ. Senator Gorton, thank you. I want to echo your sentiments in every way, shape, and form. I did so at the beginning of the hearing.

Senator Proxmire will be here in a minute or two, and he has a couple of questions for you. I have one last question. This really has to do with what we are using the existing investment stock that we now have for. According to the recent statistics I have seen somewhere, between one-quarter and one-third of all C&I loans made by banks so far in 1984 have been not for plant, not for equipment, not to finance inventories, but to finance leveraged buyouts. Does a leveraged buyout increase the capital stock or the strength of the economy in any known way?

Dr. FELDSTEIN. It might well provide an entree for new management and for reorganization. After all, the people who are putting up their money think they are going to be able to make it more profitable or they wouldn't be taking the gamble. But I think the more important point is that it doesn't use up any capital. We use up capital when we make an investment, but when I buy shares from someone else that simply transfers around ownership without using up any physical resources.

Senator HEINZ. While it may not use up any capital, does the utilization of that capital have any effect on the availability of funds for borrowing?

Dr. FELDSTEIN. Probably very little, frankly, because, after all, the money that a buyer borrows from the bank for this goes to somebody. What does he do with it? He either turns it around and puts it in a bank which is then in a position to lend it out, or he invests it in new plant and equipment. More likely, though, he puts it into other financial assets. So that is just a change in the paper ownership.

Senator HEINZ. That's an attractive argument, but what if the Federal Government runs a budget deficit and we borrow? We send the money out by return mail; it goes into somebody's bank account.

Dr. FELDSTEIN. There is a big difference. The difference is that we are purchasing goods and services, and that's why we are doing the borrowing.

Senator HEINZ. But when we purchase the goods and services the money goes into somebody else's bank account, the bank turns around and lends it out. What's the difference?

Dr. FELDSTEIN. The difference is the following.

Senator HEINZ. I always wanted to ask an economist this question on the record. [Laughter.]

LEVERAGE BUYOUT USES NO REAL RESOURCES

Dr. FELDSTEIN. If the Government buys typewriters, guns, and airplanes it is using up real resources. Those resources are not available to do anything else; they will become tied down in those typewriters, guns, and airplanes. When a firm purchases securities, and that is what a leverage buyout is, it is not using up any real resources. It's simply transferring the ownership of those resources.

I think what you have to ask is: Is somebody actually using up physical resources, is something changing in the way the physical description of the world is? If so, it has one effect, and if not, then we are talking about a purely financial transaction.

Senator HEINZ. I would submit the following and invite your comment on it. While there may be useful purposes served by leveraged buyouts, one of the things that a leveraged buyout tends to preclude for a substantial portion of time, for the company that has been leveraged and bought out, is further access to the capital markets. As a result those kind of firms have been taken out of any race for modernization or expansion.

Someone once described the leveraged buyout as a means by which a bank took a creditworthy customer and transformed them into a customer they would never lend another dollar to for many, many years to come. That suggests another question, which is this. What does it mean about our financial system when a substantial amount of lending by financial institutions is being made to customers who no longer, once the loan is made, will be creditworthy customers?

Dr. FELDSTEIN. I really hesitate to answer because I am not sure enough of the facts of the situation about leveraged buyouts.

Senator HEINZ. Let me turn the question around. Are you concerned about the overall portfolio and the quality of debt held by financial institutions?

Dr. FELDSTEIN. Sure, and I think that that is a concern that is clearly being shared by the financial market.

Senator HEINZ. Is the leveraged buyout a portion of that concern?

Dr. FELDSTEIN. It's a concern based on ignorance; it's a concern based on not fully understanding, myself, not fully understanding the implication of that.

Senator HEINZ. I share your concern as well as your ignorance on that subject. I put myself in the same category entirely. I do worry, however, when I see our financial institutions, in an effort to find just a little higher return for their loans, placing their money on what appears to my untrained eye to be relatively lower quality investments. But that is not the subject of this hearing.

I had hoped that Senator Proxmire would have arrived by now, but I don't think he is going to make it.

One last question, Dr. Feldstein. You mentioned the international debt situation. Are we taking capital funds that these debtor nations need in order to develop their own economies in order to earn foreign exchange, and pay back U.S. and other banks? Are we siphoning off capital because of our need to maintain our standard of living in this country, through our large budget deficit? Are we outbidding them for money to feather our own nest at their expense?

Dr. FELDSTEIN. Well, in reality, of course, we are still transferring more money to most of these countries. There is net lending going on to the Brazils, and Mexicos, and others. You could say, perhaps, that the high interest rates distort that measurement, that because our interest rates are so high we're seeing what amounts to much larger payments from them to us than would otherwise have occurred, and that those high interest rates in large

part reflect the budget deficits. So to that extent I think the statement that you made is correct.

Senator HEINZ. I have no further questions. I just want to add my valedictory comments to your valedictory comments, which are that you have served this country with extraordinary dedication. We are all—and I know I speak for Senator Gorton and many of us both on this and other committees—going to miss you enormously. We hope you will come back from Cambridge and visit us from time to time, and we wish you a very pleasant vacation, which is well deserved.

Dr. FELDSTEIN. Thank you very much. I certainly look forward to coming back before this and other committees in the future.

Senator HEINZ. Dr. Feldstein, thank you very much.

[Recess.]

Senator HEINZ. The hearing will come to order.

It is a privilege to welcome the Deputy Secretary of the Treasury, Mr. Tim McNamar, to our hearing on the U.S. dollar and the international competitiveness of the United States.

Tim, we just completed hearing Dr. Feldstein discussing the problems of the Federal deficit, what it meant for capital investment in this country, the difficulties it is posing now and even more serious difficulties that it poses down the road. We know also that you have been very involved in trying to straighten out some of the problems involving strong currencies and weak currencies as well as having involved yourself deeply in the International Monetary Fund [IMF], and the international debt crisis. So we are particularly pleased to have you back at this committee.

You seem to have drawn nearly a quorum of our committee with your appearance. So I commend you for that as well. Please proceed.

STATEMENT OF R. T. McNAMAR, DEPUTY SECRETARY, DEPARTMENT OF THE TREASURY

Mr. MCNAMAR. I tend to draw the quorum to the committee; Marty draws the press. [Laughter.]

It's a routine we have worked out.

I apologize for being here a little late, Mr. Chairman, but I was kicking off the hearings that the Treasury Department is having on the tax reform study that is underway.

It is a pleasure for me to appear before this committee to discuss the U.S. trade deficit. I have prepared a comprehensive written submission which deals with the trends in the U.S. trade balances as well as its causes and effects.

In my statement this morning, to complement Marty's, to respond to your written invitation, I would like to focus mainly on the exchange rate issues, because these do have an impact on the trade deficit.

THREE MAJOR CAUSES FOR WIDENING TRADE DEFICIT

There have been three major causes for the widening of our trade deficit in recent years. They are the strong U.S. economic recovery which occurred at a time of slower and weaker economic growth in other major industrial countries.

Second, the sharp decline in our exports to developing countries that are experiencing financial problems.

And third, the appreciation of the dollar on exchange markets over the past 3½ years.

I have listed these factors and estimates of their effects on chart No. 1, which is attached to my statement. We will use some flip charts to go through these here as well, if we may.

As you can see, the range of estimates for the direct effect of high U.S. and weak foreign growth on our trade balance is about $25–$30 billion this year. We would estimate that the widening of our trade deficit caused by international debt problems would also be at least $25–$30 billion. Finally, there is a very wide range of estimates on the impact of dollar appreciation on our trade position, running as low as $25 billion and as high as $100 billion this year.

Summing up, the first point I would like to make is that while dollar appreciation has had a significant impact on our trade deficit, it is far from the only influence and is the most difficult to estimate with any precision.

Let me talk about exchange rate developments.

Because there are many who would argue that regardless of how large or small the impact of dollar appreciation is it has been artificial and unhealthy. Thus we are told that the dollar has been driven up unnecessarily by an excessive U.S. budget deficit and high U.S. interest rates. In response I would point out that whatever connection one believes there may be between budget deficits and interest rates, and the evidence on that issue is uncertain at best, empirically there has been very little correlation between interest rates and exchange rates. On balance, over the last 3 years the dollar appreciated substantially against all major currencies, yet interest rate differentials moved against the dollar.

The work we have done at Treasury suggests that movements in real interest rates and real exchange rates are also not closely correlated with any single variable analysis.

More fundamentally, appreciation of the dollar over the past 3½ years reflects the normal workings of the international adjustment process. The concept that the dollar has become overvalued is intuitively appealing but a poor guide to economic policy.

Most estimates of the degree of dollar overvaluation are based on the assumption that the exchange rate between any two countries should move only to offset differing national inflation rates so as to keep the international price competitiveness of traded goods unchanged. Decades of economic research, however, have failed to verify this simplistic purchasing power parity theory of exchange rate determination. It should not be too surprising since it is only designed to explain one dimension of the behavior of merchandise trade which today is only a small part of total international transactions. At present the sum of all global transactions in goods and services last year has been estimated at about $2 trillion. By contrast, international currency transactions have been estimated at levels like $100 billion per day, or a ballpark range of $20–$30 trillion. Thus the vast bulk of transactions in the foreign exchange markets are capital transactions, and the dynamics of the foreign exchange market reflect that fact.

CAPITAL FLOW ALTERS EXCHANGE RATE

International investors alter exchange rates by shifting their portfolio preferences toward investments in countries where the anticipated relative aftertax real rate of return from investment of comparable maturity and financial uncertainty is higher given similar risks, and when investors sense that there are current or prospective developments which will significantly alter relative rates of returns to capital they react accordingly. Over time the resulting international capital flows help to achieve a more efficient allocation of resources.

Clearly there are a huge number of economic and political factors which influence expectations about the real aftertax rates of return to investment in different countries. Anything which might have a significant influence on inflation and growth performance, business profitability, tax policies, credit markets, stock market trends, labor market, government regulations, or the overall economic and political environment can have an impact.

Furthermore, any observer or analyst who wants to make sweeping statements about one or another of these influences has to take into account the way markets operate. There are thousands of active traders in the foreign exchange market, and on any given day they may do business directly or indirectly with millions of customers. The collective market response to economic and political events is the end result of the interaction of all these transactors.

In this environment it seems farfetched to suggest that there are unchanging, well-defined weights or coefficients attached to reach the myriad determinants of exchange rates. I don't know what the weights are and I don't believe they remain constant over time, and I would certainly recommend that you look with skepticism on anybody who claims to know that.

In short, I believe that the only intellectually defensible position is that of the agnostic. But while I cannot tell you the exact significance of any one factor, I would like to suggest a brief outline of some of the factors which have been driving exchange rate movements.

Over the past 3½ years a number of factors have led investors to expect a higher real aftertax rate of return on investment in the United States. They include, first, fundamentally better U.S. economic performance and prospects in inflation, growth, and business profitability.

The President's economic recovery program brought a historic turnaround in U.S. inflation performance, as shown on chart 2. You can see that in 1979–80 the United States was a high-inflation country and most international investors then expected that our inflation rate would get worse as time went on. As you can see on the bottom of the chart, we have now shifted to a low-inflation country along with Germany, Japan, and the United Kingdom.

The dramatic turnaround in U.S. inflation performance was followed by vigorous economic recovery. However, as is shown in chart 3, our economic upturn has not been matched by the strength of recovery in other industrialized countries.

There has been a dramatic improvement in the profitability of American business as a result of noninflationary U.S. recovery and the relatively more favorable depreciation allowances and other incentives under the Economic Recovery Tax Act of 1981.

I would particularly like to draw your attention to chart No. 4 which summarizes one of these factors, and just one, the length of time over which business investment is written off for tax purposes in each of the largest industrialized countries. Since the enactment of ACRS the United States has moved toward expensing. This relative shift—and I would emphasize relative shift—to the writeoff periods indicated in chart 4 means that since 1981 we have the shortest period for writing off business investments of any of the largest industrialized countries, which has yielded a considerable increase in corporate cash flow. Investments in industrial equipment are now written off over 5 years; an industrial plant over 15 years, whereas prior to ACRS the writeoff periods were 8½ years and about 24 years respectively. So we have moved from 8½ to 3–5 and from 24 years to 10–15 respectively.

Thus in 1981 again there was a relative shift in the anticipated aftertax rate of return for direct investments in the United States.

In addition, rates of return to business investment in Europe are still significantly depressed by the long tradition of protecting labor incomes and employment from the influence of market forces. This tradition has not only created disincentives to investment, but it also led to an absolute decline in the number of employed workers in Europe.

As indicated in chart No. 5, European employment both during the decade of the 1970's and over the past few years has declined. In contrast, the United States has added 21 million jobs in the 1970's and another 6 million in the current upturn. Japan has been somewhere in the middle with fewer new jobs than the United States in both absolute and percentage terms.

I think chart 5 well illustrates the fact that if you look at the United States versus Japan, for example, since 1980 we have had a 6-percent increase in jobs here, Japan only 4-percent, France a slight decline, Germany a 5-percent decline, and the United Kingdom a 6-percent decline. And I have to say that in Germany I am not confident of my numbers. They may be understating in that I am not certain how the Yugoslavian and Turkish guest workers who left versus those who stayed in Germany are counted. So if anything, I would suggest that number may be too conservative.

DOLLAR STRENGTHENED BY INFLOWS OF SAFE HAVEN CAPITAL

Finally, the dollar has been strengthened by inflows of safe haven capital prompted by economic and political turmoil in the Middle East, Latin America, and Eastern Europe. These are capital flows which are placed to protect assets from destruction or its appropriation, such as the flight of money from several countries in Latin America in recent years.

Many other events in recent years have also prompted such safe haven capital flows, including fears of nationalization in France, tensions in Eastern Europe, conflicts in Lebanon and the Persian Gulf, and even events in Germany, such as the missile debate,

banking problems, political scandals, and the current very unclear labor market situation in Germany.

Under these circumstances keeping the dollar from appreciating would have required us to weaken our own economy to match the rest of the world. It is difficult to argue that a relatively healthy U.S. economy is undesirable. Similarly, we see no reason to be concerned about an orderly depreciation of the dollar.

Against this background several of the factors which have been pushing up the dollar are now shifting. International investors may be recognizing that the most rapid and dramatic improvements in the U.S. economy have already happened and that many other industrial countries are catching up. Similarly, the deceleration in U.S. inflation relative to the other major industrial countries has slowed and we are entering a period of relatively similar inflation rates, but low ones by recent standards. The point here is that any anticipated relative shifts are now fairly small, unlike the 1981–83 period.

In addition, as some troubled debtor nations come to grips with their problems capital flight is reduced.

Finally, at some point currency depreciation in response to widening current account deficit is a normal part of the international adjustment process. Over time dollar depreciation should help to moderate both the U.S. trade and current account deficits and foreign surpluses.

In recent weeks exchange markets have been unsettled at times, and while all of the longer term influences on exchanges rates which I have already mentioned are still operating, there have also been many short-term factors which have pulled the markets in different directions. Concerns over conflict in the Persian Gulf have tended to increase the safe haven demand for dollars and have reduced confidence in the outlook for countries which are heavily dependent on imported oil from that region, such as Japan, which as I recall gets about 65 percent of its oil through the Strait of Hormuz; unrest in the European labor market has also added pessimism about the near-term prospects for that region; the problems of Continental Illinois Bank and unfounded rumors about other U.S. banks have in turn led to occasional downward pressure on the dollar. The net result of all these factors has been a very uncertain exchange market.

Another major factor which exchange markets are now attempting to digest is the recent agreement between the United States and Japan on yen/dollar issues. Since President Reagan came into office we have been discussing exchange rates and capital market issues with the Japanese Government. President Reagan personally conveyed our deep concerns about these issues during his talks with Prime Minister Nakasone in Tokyo last November. In the joint press announcement President Reagan and Prime Minister Nakasone expressed their "mutual commitment toward specific steps to achieve open capital markets to allow the yen to reflect more fully Japan's underlying political stability and economic strength as the second largest economy in the free world."

We believe that they are on their way to meeting that commitment and to taking their position as the second most powerful nation in the free world in economic terms.

At Treasury we have been concerned that the yen's role in the international financial system was not commensurate with Japan's role as a great world economic and trading power.

YEN/DOLLAR ISSUE

As shown in chart No. 6, Japan's restrictive policies have inhibited the use of the yen internationally, adversely affected the yen/dollar exchange rate, created distortions and inefficiencies in Japan's capital markets, and posed unfair barriers to U.S. firms seeking to operate in Japan. The report on yen/dollar issues which Secretary Regan released last week contains major new commitments and policy measures by Japan that we believe will, when fully implemented, redress many of the problems which have existed and put to rest the accusation that Japan rigs the yen.

The important policy changes announced by Japan will occur in three broad areas which I have outlined in chart No. 6. These three areas are the Euroyen market, the operations of Japan's domestic capital market, and access of foreign financial institutions to the Japanese capital market.

First, as to the development of the Euroyen market as an area most important to the internationalization of the yen. Japan has now made the basic commitments and decisions necessary to allow for the development of the Euroyen bond and banking markets where non-Japanese can borrow in the yen outside Japan and investors will be able to buy a wider range of yen denominated instruments.

As a result of the announcements contained in the working group report the future development of the Euroyen market will proceed almost as free of regulation as the Eurodollar market. These policy changes will undoubtedly lead to a major increase in the role of the yen as an international currency.

Second, substantial changes in Japan's domestic capital market policies have also been announced. As part of the continuing process of liberalizing Japanese capital markets the Japanese Government affirmed its intention to deregulate interest rates, focusing first on large denomination deposits and then on small deposits. Japan also indicated a willingness to allow deregulation to proceed as quickly as market forces warranted, including the introduction of new financial instruments with freely determined interest rates.

Part of the liberalization process was a broadening of the funding and lending basis for foreign financial institutions, which will enable them to operate on a more competitive basis with Japanese firms. We believe that these and other important changes will allow market forces to play an increasing role in that market.

Third, the Ministry of Finance also announced a number of important changes which affect the ability of foreign financial institutions to do business on an equal footing with Japanese financial firms in Japan's capital markets. These changes include such measures as allowing foreign banks to participate in trust banking and increasing the transparency of Government policies affecting the operation of foreign financial institutions in Japan.

The Japanese Government is also committed to finding a solution to the question of foreign membership in the Tokyo stock exchange.

These steps will create effective competitive opportunities for foreign financial institutions, reflecting Japan's commitment to the principle of national treatment. As these measures are fully implemented over time they should help bring the exchange market value of the yen more into line with Japan's underlying economic strength.

As is probably clear by now, we do not believe that the widening trade deficit should precipitate major changes in U.S. economic policies. Many possible U.S. policy changes would be counterproductive. In addition, we believe that forces are already in motion, such as Government policy actions to strengthen economic performance and manage debt problems and through the working of the international adjustment process, to address the major causes of our widening deficit.

Protectionism is clearly counterproductive. It has a serious negative impact on the U.S. economy through a general increase in inflation, higher prices to industries dependent on imported products, and the risk that countries affected by the import restraints will retaliate. In the absence of retaliation, protectionist measures tend to produce further dollar appreciation, which would be offset by their intended positive impact on the trade balance.

Finally, measures of this type by the United States would cut the ground from under our efforts to restrain protectionism by other countries and deal a serious blow to the noninflationary world recovery which is now getting underway.

In conclusion, I would argue that we are already doing everything we can profitably to deal with the trade situation. We are encouraging other countries, developed and developing, to get their own houses in order, and we are continuing our efforts to strengthen the U.S. economic policies and performance, including a determined effort to reduce future budget deficits in a balanced and responsible manner.

Thank you, Mr. Chairman and members of the committee. I apologize for a slightly overly long statement.

[The complete statement follows:]

FOR RELEASE UPON DELIVERY
June 6, 1984

STATEMENT OF THE HONORABLE R. T. MCNAMAR
DEPUTY SECRETARY OF THE TREASURY
BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
UNITED STATES SENATE
June 6, 1984

Mr. Chairman, Senators, it is a pleasure for me to appear before this Subcommittee to discuss the U.S. trade deficit. This is a complex topic on which views can differ substantially, and I am under no illusion that every observer agrees with the Administration's policy approaches in this area. However, our policies are grounded in the facts, and I would like to share our analysis with you today.

There has, of course, been a substantial widening of the trade deficit. Measured in the way that it enters our overall balance of payments, the trade deficit averaged $30 billion per year from 1977 to 1982. Last year it grew to $61 billion, and most forecasts suggest it will exceed $100 billion this year (Table 1).

Geographically, this widening of our trade deficit has been fairly widespread (Table 2). Given the hue and cry about Japanese exports, one would expect to find that our trade deficit with Japan was a leading cause of the widening of our trade deficit. In fact, our deficit with Japan only widened by $4 billion between 1981 and 1983, mainly due to higher U.S. imports. That is, while access for U.S. goods to the Japanese market is not all we would like it to be, there has not been a major deterioration in U.S. export performance with Japan.

U.S. trade with other industrial countries has not held up as well as our trade with Japan. Between 1981 and 1983, our exports to these countries fell by $15 billion, and our trade balance with them shifted from a $13 billion surplus to a deficit of $8 billion last year.

By far the largest U.S. trade balance deterioration has been with Mexico. Our exports to Mexico dropped by roughly half, from $18 billion in 1981 to $9 billion last year. With rising U.S. imports, our balance with Mexico swung from a $4 billion 1981 surplus to a deficit of $8 billion last year. Adding in smaller declines with other less developed countries, our overall trade balance with non-OPEC LDCs worsened by $22 billion from 1981 to 1983.

Bucking the tide was our trade with OPEC member countries. Driven by forces set in motion by OPEC itself, oil consumption in the United States and other oil-importing countries has continued to plummet, helping to drive down oil prices. The daily average volume of U.S. oil imports, at 5.2 million barrels per day in 1983, was 44 percent below the peak rate of 9.27 million barrels per day reached in 1977. Despite vigorous U.S. economic recovery, oil import volume remained at only 5.4 million barrels per day in the first quarter of this year.

The cost of imported oil, measured by oil import unit values, averaged about $28.37 per barrel last year, down from $34 in 1981. This average cost declined further in the first quarter of this year, to $28.05 per barrel.

The combined impact of these forces has helped trade balances in all oil-importing countries -- particularly the United States. U.S. imports from OPEC dropped by half, from $50 billion in 1981 to $25 bilion last year. While OPEC in turn had to cut back its imports from the United States by $6 billion, the net impact on our trade balance was still positive by $19 billion.

Trade performance by commodity group has fewer surprises (Table 3). U.S. oil imports dropped by $24 billion from 1981 to 1983. Other imports, which had fallen in the 1982 recession, grew strongly during our 1983 recovery and stood $19-1/2 above their 1981 level. Our exports, in contrast, continued to fall on a year-over-year basis. Agricultural exports in 1983 stood $7-1/2 billion below their 1981 peak, and non-agricultural exports were down $29-1/2 billion. This year, we expect increases in both agricultural and non-agricultural exports totalling perhaps $15 billion. This will, however, be more than offset by increases in U.S. imports totalling perhaps $60-65 billion.

Taking into account U.S. trade in both goods and services, as well as transfer payments and receipts, the U.S. current account swung from a surplus of $4-1/2 billion in 1981 to a $41 billion deficit last year (Table 3). In addition to the $32-1/2 billion widening of our trade deficit over this period, there was a $1-1/2 billion increase in net U.S. transfer payments abroad and an $11 billion decline in our surplus on net service transactions. This decline came almost entirely through reduced net income on our overseas investments. While we expect some recovery in investment income, next year's current account deficit will likely be in the $80 billion range.

These are very large figures, both in absolute terms and as a percentage of our Gross National Product. They lend themselves to dramatic rhetoric and calls for urgent action. In my remarks today, I will address a number of important issues which need to be borne in mind by the Congress and by the Administration in reacting to these requests. These issues include the causes of the widening of our trade deficit, the impacts of the deficit on both the American economy and the rest of the world, and our views on the appropriate policy response.

The Causes of a Widening Trade Deficit

In broad terms, there have been three major factors in the widening of our trade deficit. These are: the strength and timing of the U.S. economic recovery; declines in our exports to developing countries which are experiencing financial problems; and the appreciation of the dollar on exchange markets over the past three years. Table 4 gives rough orders of magnitude for the impact of each of these factors.

In the United States, the trough of the last recession came late in 1982. During 1983, our real GNP expanded 6.2 percent -- a strong rebound, and about in line with the first year of other recoveries in the postwar era. As indicated in Chart 1, real growth in other major industrial countries, in contrast, was only 3 percent last year, and even by the end of the year a sustained upturn was not yet underway in some of those countries. Signs are that a strong U.S. recovery is persisting into 1984, as reflected in the current Administration forecast of 5 percent real growth, while economic recovery will continue to gather steam in most of the major foreign industrial countries this year, reaching about 4 percent.

In qualitative terms, the impact of the relatively strong U.S. cyclical position on our trade balance is quite clear: our strong recovery has led directly to rapid increases in U.S. imports, while growth in our major export markets has failed to keep pace. A ballpark estimate for the "growth gap" in our trade balance is $25 to $30 billion this year.

A slow recovery in the industrial world has not been the only problem for U.S. export markets. We are also a major exporter to developing countries -- and our trade performance has been strongly influenced by their debt problems over the past two years. The inability of these countries to finance previous levels of imports was the major reason for the 50 percent drop in U.S. exports to Mexico from 1981 to 1983, which I cited earlier, and for our $22 billion trade-balance deterioration with all non-OPEC LDCs. Similar financial problems in Eastern Europe were reflected in a $1-1/2 billion decline in U.S. exports to that region, as well. Finally, while there is no way to quantify it, LDC debt problems have undoubtedly had an indirect negative effect on our exports to other industrial countries, by lowering their own exports and real growth. Overall, a ballpark estimate of the debt-related part of the widening of our trade deficit would be at least $25 to $30 billion.

Finally, a significant portion of the U.S. trade deficit was also attributable to the appreciation of the dollar on foreign exchange markets. Between the beginning of 1981 and this January, the dollar appreciated roughly 30 percent on a weighted-average basis against other major currencies. Although it depreciated slightly early in 1984, roughly two years must pass before the full impact of exchange rate changes is reflected in our trade balance. As a result, the exchange rates driving this year's trade deficit will still be mainly those of 1981-1983, when the dollar was appreciating.

Dollar appreciation, to the extent it is not offset by relatively better U.S. inflation performance or other factors which improve our competitiveness, makes it more difficult for U.S. businesses to compete with foreign firms. This is true both in our domestic market, where foreign goods become cheaper for U.S. consumers, and in our export markets, where dollar-priced goods become more expensive in terms of the local currency.

While there is general agreement on the direction of the impacts of exchange rate changes on trade flows, it is much more difficult to pinpoint the size of those impacts. There are a number of analytical techniques which can be applied to this issue, which yield significantly different estimates, and in addition small changes in the application of a given technique can produce large changes in the result. Estimates which attribute to dollar appreciation the residual part of the widening of our trade deficit -- the part which is not explained by relative growth rates or debt problems -- run as low as $25 billion for 1984. At the high end of the range are estimates from simple econometric models which reach as much as $100 billion. There are substantial technical problems with all methods of performing this calculation, and econometric models in particular have poor track records in predicting the impacts of large shifts in economic variables. The most we can say with confidence is that the truth is probably somewhere in the $25 to $100 billion range.

Exchange Rate Developments

There are many who would argue that, regardless of how large or small the impact of dollar appreciation actually is, it has been artificial and unhealthy. Thus, we are told that the dollar has been driven up unnecessarily by an excessive U.S. budget deficit and high U.S. interest rates. We are offered precise calculations of the degree to which the dollar is "overvalued" -- figures typically ranging from 20 to 30 percent.

On balance over the last three years, the dollar appreciated substantially against all major currencies -- yet interest rate differentials moved against the dollar. Between the beginning of 1981 and the end of last year:

-- the dollar appreciated by 38 percent against the German mark, 83 percent against the French franc, and 14 percent against the Japanese yen;

-- while interest rate differentials moved against dollar assets, by 5 percentage points for Germany, over 9 percentage points for France, and nearly 6 percentage points for Japan.

A more meaningful economic argument can be made linking high real interest rate differentials with a strong dollar. It is notoriously difficult to measure real interest rates, given the central role played by inflation expectations in determining the real interest rates perceived by investors. Work we have

done at Treasury suggests that there has been little correlation between movements in real interest rates and real exchange rates. However, all such empirical work is very sensitive to the means chosen to approximate expected inflation rates in the United States and the other major industrial countries, and it is possible to obtain a wide variety of differing estimates.

More fundamentally, the appreciation of the dollar over the past 3-1/2 years reflects the normal working of the international adjustment process. The concept that the dollar has become "overvalued" is intuitively appealing, but a poor guide to economic policy. Most estimates of the degree of dollar "overvaluation" are based on the assumption that the exchange rate between any two countries should move only to offset differing national inflation rates, so as to keep the international price-competitiveness of traded goods unchanged.

Decades of economic research, however, have failed to verify this simplistic "purchasing power parity" theory of exchange rate determination. This should not be too surprising, since it is only designed to explain one dimension of the behavior of merchandise trade -- which in turn is only a small part of total international transactions. The sum of all global transactions in goods and services last year has been estimated at about $2 trillion. By contrast, international currency transactions have been estimated at $100 billion per day -- or a ballpark range of $20 to $30 trillion per year. Thus, the vast bulk of transactions in the foreign exchange markets are capital transactions, and the dynamics of those markets reflect that fact.

International investors act on their perceptions of where real, after-tax rates of return to capital will be highest, and they constantly weigh the relative attractiveness of assets denominated in different currencies. Thus, when investors sense that there are current or prospective developments which will significantly alter relative rates of return to capital, they react accordingly. Over time, the resulting international capital flows help to achieve a more efficient allocation of resources.

Now, clearly there are a huge number of factors, both economic and political, which influence expectations about the real, after-tax rates of return to investments in different countries. Anything which might have a significant influence on inflation and growth performance, business profitability, tax policy, credit market conditions, stock market trends, labor markets, government regulations, or the overall economic and political environment facing businesses can have an impact.

Furthermore, any observer or analyst who wants to make sweeping statements about one or another of these influences has to take into account the way in which these markets operate. There are thousands of active traders in the foreign exchange market, and on any given day they may do business, directly or indirectly, with millions of

customers. The collective market response to economic and political events is the end-result of the attitudes and interactions of all of these transactors.

In such an environment, it seems far-fetched to suggest that there are unchanging, well-defined weights or behavioral equations which describe the reaction of the market to each of these determinants of exchange rates. I don't know what those weights might be, if they exist they certainly must change dramatically over time, and I would certainly recommend that you greet with skepticism anybody who does claim to know what they are.

But while I cannot tell you the exact significance of any one factor, I would like to offer a brief outline of some of the factors driving exchange rate movements. Among the major factors influencing market perceptions of real rates of return to capital over the past 3-1/2 years have been: fundamentally better U.S. economic performance and prospects; weaker performance and prospects in other major industrial countries; and the threat posed by economic and political turmoil in the Middle East, Latin America, and Eastern Europe. Our economic program brought a historic turnaround in U.S. inflation performance (Chart 2), followed by vigorous recovery. As a result of our non-inflationary recovery, deregulation, and more favorable depreciation allowances under the Economic Recovery Tax Act of 1981, the profitability of American business investment has improved dramatically. Foreign economic prospects and business conditions, especially in Europe, did not keep pace with ours (see, for instance, Charts 1-3). And in many troubled parts of the globe, concerns over possible expropriation, capital controls, or physical destruction of assets led to "safe haven" capital flows into the world's strongest and most stable country.

Under such circumstances, keeping the dollar from appreciating would have required us to weaken the U.S. economy to match the rest of the world. It is difficult to argue that a relatively healthy U.S. economy has been undesirable. Similarly, we would not be concerned about an orderly depreciation of the dollar.

Several of the factors which have been pushing the dollar up are now shifting. International investors may be recognizing that the most rapid and dramatic improvements in the U.S. economy have already happened, and that many other industrial countries are catching up. Similarly, the historic turnaround in U.S. inflation performance has largely run its course for now, and we are entering a temporary period of slightly higher inflation rates. Finally, at some point currency depreciation in response to a widening current account deficit is a normal part of the international adjustment process. Over time, dollar depreciation should help to moderate both the U.S. trade and current account deficits and foreign surpluses.

Exchange markets have been unsettled at times in recent weeks. While all of the longer-term influences on exchange rates which I have already mentioned are still operating, there have also been many short-term factors which have pulled the market in different directions. Concerns over the conflict in the Persian Gulf have

tended to increase the "safe haven" demand for dollars and have reduced confidence in the outlook for countries which are heavily dependent on imported oil from that region. Labor problems in Europe have also added to pessimism about near-term prospects for that region. The problems of Continental Illinois Bank, and rumors about other U.S. banks, have in turn led to occasional downward pressure on the dollar. The net result of all of these factors has been a very uncertain exchange market.

Another major factor which exchange markets are now digesting is the recent agreement between the United States and Japan on yen/dollar issues. Since President Reagan came into office, we have been discussing exchange rate and capital market issues with the Japanese government. President Reagan personally conveyed our deep concern about these issues during his talks with Prime Minister Nakasone in Tokyo last November. In their Joint Press Announcement, President Reagan and Prime Minister Nakasone expressed their "mutual commitment toward specific steps to achieve open capital markets [to] allow the yen to reflect more fully Japan's underlying political stability and strength as the second largest economy in the free world."

We have been concerned that the role of the yen in the international financial system has not been commensurate with Japan's role as a great world economic and trading power. Japan's restrictive policies have inhibited the use of the yen in international transactions, adversely affected the yen/dollar exchange rate, created distortions and inefficiency in Japan's capital markets, and posed unfair barriers to U.S. firms seeking to operate in Japan. The report which Secretary Regan released early last week contains many new commitments and policy measures by Japan that we believe will, when fully implemented, redress many of these problems.

The important policy changes announced by the government of Japan will occur in three broad areas: the Euroyen market, the operation of Japan's domestic capital market, and access by foreign financial institutions to the Japanese capital market. I would like to outline what is involved in each of these areas.

Development of the Euroyen market is the area most important to the internationalization of the yen. Japan has now made the basic commitments and decisions necessary to allow for the development of Euroyen bond and banking markets, where non-Japanese can borrow in yen outside Japan and investors will be able to buy a wider range of yen-denominated financial instruments.

Substantial changes in Japan's domestic capital market policies have also been announced. The Japanese government affirmed its intention to deregulate interest rates, focussing first on large denomination deposits and then on smaller deposits. We believe that these and other changes will allow market forces to play an increasing role in the Japanese capital market.

The Japanese government also announced a number of important changes which affect the ability of foreign financial firms to do business on an equal footing with Japanese financial firms in Japan's capital market. These changes include such measures as allowing foreign banks to participate in trust banking, increasing the transparency of government policies affecting the operations of foreign financial institutions in Japan, and eliminating swap limits. They will create effective competitive opportunities for foreign financial institutions, reflecting Japan's commitment to the principle of national treatment.

As these measures are fully implemented over time, they should help to make the yen a true international currency, on the same footing as the dollar, the British pound, and the German mark. The long-run result should be a significant strengthening of the yen, to bring its exchange market value into line with the underlying strength of the Japanese economy.

Impacts on the U.S. and Global Economy

Despite occasional assertions to the contrary, a widening U.S. trade deficit has not been an unmitigated disaster for either the United States or for the rest of the world. For each there are both gains and losses, and trade developments cannot be judged in isolation from other economic developments and policies.

In the United States, there can be no question that firms in our traded-goods industries are finding life more difficult. Particularly as a result of dollar appreciation, they must cut costs (and in some cases profit margins) in order to compete with foreign goods in both our domestic market and in markets overseas. One result may be that the direct impact of the deficit will be to make output and employment in these industries lower than it otherwise might have been. However, it should be remembered that the widening trade deficit is, to a large extent, an indirect result of our success in cutting inflation and revitalizing the American economy. The benefits of our policies and our non-inflationary recovery have helped to offset negative impacts of a bigger trade deficit, not only for the economy as a whole but also for traded-goods industries. Profit reports, stock market results, and production and employment gains in U.S. manufacturing industries (Chart 4) do not seem to indicate a "deindustrialization" of America.

In addition, for American consumers as a group there are significant gains from a lower cost of imported goods, which leads directly to lower inflation and increased real buying power. Greater foreign competition impacts indirectly on our inflation rate, as well, by keeping the pressure on U.S. firms for lower costs, greater efficiency, and lower prices. Service industries, which compete primarily for domestic sales against other U.S. firms, reap the benefits of lower inflation and thus tend to have rising output and employment.

Some analysts have complained that the strong dollar and widening trade deficit are causing the current U.S. recovery to be "unbalanced" and therefore unsustainable. I don't think the facts support this claim. As indicated in Table 5, not only was our 6.2 percent real GNP growth rate during 1983 about in line with growth at the same stage of previous recoveries, but the pattern of that growth was healthy. Consumer spending (particularly durables purchases), housing, business investment, and even exports all made greater contributions to this recovery than in previous ones. Weaker than average contributions came from Federal, state and local government spending and from net exports.

What is particularly striking is that interest-sensitive categories all made greater-than-average contributions to the recovery -- and that business investment, which is so crucial to sustained growth, is booming most of all. So far this year, strong growth is continuing, as indicated by the 8.8 percent real GNP growth rate for the first quarter -- and all signs are that fixed investment is still a leading component.

Parenthetically, I would note that it is sometimes difficult to know which of two conflicting concerns of our critics we are supposed to be taking more seriously. On the one hand, one is treated to calculations of how much higher U.S. growth and employment might have been without the widening of the trade deficit -- estimates which of course ignore the fact that the trade deficit is largely a result of a strong U.S. recovery which has added over 6 million jobs to the labor force over the past year and a half. On the other hand, there is the recurrent theme of how unsustainably rapid our real GNP growth rate has been over that same period; surely critics who believe that adding 6 million jobs was too much would have been even more horrified by additional employment gains.

For the rest of the world, the impacts of our trade deficit are in many ways a mirror image of impacts on the United States. Traded goods industries in other countries gain output and employment; there is also a temporary upward pressure on foreign inflation rates from higher import costs. Trade gains with the United States have been a significant factor in helping to solidify the hesitant economic recovery in Europe. Exact estimates of the impact of U.S. growth on growth in other countries are difficult. One set of illustrative figures obtained using OECD models suggests that export gains caused by strong U.S. recovery accounted for 2 percentage points out of Canada's 6.6 percent real GNP growth last year, nearly one percentage point out of the 2.7 percent British growth rate, and for 1.2 percentage points out of Germany's 2.9 percent real growth.

In the longer term, improved trade balances in less developed countries are necessary to enable them to service their debt in an orderly manner, and for these improvements to take place there must inevitably be a counterpart swing towards deficit among their trading partners. Our widening deficit is clearly facilitating the economic adjustments which financially troubled developing countries must make to resolve their international debt problems. Thus, for

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example, U.S. imports from the six largest Latin American debtors grew by nearly 30 percent in the first quarter of this year from year-earlier levels. In dollar terms, this is an annual-rate increase of about $8 billion. There have been similar, or larger, gains for debtors elsewhere -- U.S. imports from Asian and African LDCs in the first quarter were up by 45 percent, or a $15 billion annual rate.

The charge is sometimes made that a large U.S. trade and current account deficit causes the United States to "drain capital" out of the rest of the world, thereby damaging other countries. In balance of payments accounting, it is undeniably true that a current account deficit must be parallelled by transactions of equal size, and opposite sign, elsewhere in the balance of payments. These parallel transactions are usually thought of as being capital transactions, so that a U.S. current account deficit by definition would mean there is also a net capital inflow to the United States.

There are a number of fundamental problems with the "draining capital" accusation, however. The first is the influence of the statistical discrepancy, as clearly reflected in U.S. capital account data for 1982 (Table 6). Our 1982 current account deficit of $11 billion might have implied an $11 billion net capital inflow, if there were no statistical discrepancy in our balance of payments. However, in fact there was a recorded net capital outflow of $30 billion in 1982, and the accounts were balanced by a positive statistical discrepancy of $41 billion. By definition, we do not know what sorts of transactions contributed to the discrepancy -- and while the possibilities for measurement error and reporting gaps are probably greatest in the capital account, the existence of a large discrepancy casts some doubt on all of our balance of payments data.

A second basic flaw in the "draining capital" argument can be seen in the 1983 data. Last year the statistical discrepancy was rather small ($7 billion), so our $41 billion current account deficit was reflected mainly in recorded net capital inflows, totaling $34 billion. However, the 1982-83 swing from net capital outflows to net inflows was not the result of higher inflows of foreign capital to the United States: these inflows actually fell by $5 billion, from $88 billion in 1982 to $83 billion last year. What caused a net inflow was that outflows of U.S. capital fell by even more -- by $69 billion. U.S. investors, and particularly U.S. banks, reduced their foreign lending dramatically, while foreigners also invested somewhat less in the United States.

The third flaw is the issue of causation. The sharp slowdown in U.S. lending abroad last year came mainly with developing countries. This reflected a dramatic change in bankers' perceptions of the risk attached to lending to many LDCs. The proximate cause of this change in the pattern of U.S. capital flows was thus fundamental doubt about the creditworthiness of some major LDC borrowers prompted by excessive borrowing and inadequate economic adjustment -- not U.S. interest rates or budget deficits.

The U.S. Policy Response

As is probably clear by now, we do not believe that the widening trade deficit should precipitate major changes in U.S. economic policy. Some of the measures which are urged on us are impractical or even counterproductive. In addition, we believe that forces are already in motion -- both through government policy actions to strengthen foreign economic performance and manage debt problems, and through the working of the international adjustment process -- to address the major causes of our widening deficit.

One set of policy responses which we have consistently rejected is direct action to drive down the dollar's exchange market value. As was demonstrated by the thorough international study of foreign exchange market intervention carried out between the Versailles and Williamsburg Summits, intervention does not have a significant or lasting impact on exchange rates. Attempts to use intervention to permanently alter exchange rate levels are doomed to failure.

If intervention sales or purchases are done in such a way that they are permitted to alter the course of domestic monetary policy -- that is, if they are "unsterilized" in the technical jargon -- they can have a lasting impact. However, this can be a misleading way of looking at what is really going on in such a case: the factor which would alter exchange rate behavior would be that there had been a change in monetary policy, not that it had taken place in connection with intervention. There is no doubt that we could drive down the dollar very rapidly by reigniting rapid inflation through excessive money growth -- but I cannot seriously believe that the American people want to undo all we have done to bring inflation under control and revitalize our economy. Furthermore, while we would quickly see the inflationary results of excessive monetary expansion in our domestic economy, the positive effects of dollar depreciation on our trade balance would take roughly two years to reach their full extent, as I noted earlier.

Some observers have suggested that we use capital controls to force down the dollar. I suspect even the proponents recognize that imposing capital controls would be a self-destructive act, and are only suggesting them for dramatic effect. In brief, I would note that capital controls the United States has tried to use in the past have not worked particularly well. More fundamentally, to the extent that new U.S. controls did work they would have major negative impacts on domestic and international capital markets, could lead to interest-rate increases and sectoral credit shortages, and would undermine the longer-term confidence of international investors in the U.S. dollar as a transactions currency and the U.S. economy as a place to invest.

As I mentioned earlier, in the case of the Japanese yen we have been working hard to remove capital market restrictions and imperfections which we believe tended to keep the yen from fully reflecting market forces.

There have been suggestions that a massive tax increase is needed to eliminate the trade deficit. I suppose such an action could have a significant and immediate impact if it were to drive the U.S. economy into a steep recession -- but I don't think that's exactly what the proponents have in mind. They are operating from the presumption that our Federal budget deficit is the primary reason for the widening trade deficit, a presumption which I have challenged in my earlier analysis.

However, the Administration is working with the Congress, in a bipartisan way, to reduce the budget deficit in a manner which will not otherwise harm the American economy. The primary cause of the large budget deficit is excessive growth of Federal spending, and the primary means of reducing the budget deficit should be expenditure restraint. Currently we are working with the Congress on a balanced three-year package of expenditure and revenue measures. For the longer-term, President Reagan has proposed other initiatives, including a balanced budget amendment and line-item veto authority.

There have been proposals over the past year to "correct" the U.S. trade deficit, and to modify the impact of foreign competition on U.S. industries, by restricting foreign access to the U.S. market or by subsidizing U.S. exports.

Protectionism is not cost-free by any means. Its drawbacks are clear and well known to you, so I will only summarize them briefly. Protectionism can have a serious impact on other sectors of the U.S. economy by increasing the overall inflation rate, raising input prices for industries dependent on the protected imports, and risking that foreign countries affected by U.S. import restraints will retaliate.

In addition, import surcharges, quotas, tariffs, or export subsidies would likely be offset by further dollar appreciation which would offset their intended trade-balance impacts. Some measures of this type can yield temporary gains for specific industries or firms, but only at the cost of offsetting losses to other U.S. industries and firms. Finally, I would note that such measures by the United States would cut the ground from under our efforts to restrain protectionism by other countries. A generalized increase in protectionism would deal a serious blow to the non-inflationary world recovery now developing.

U.S. industries do have a legitimate right to seek redress from unfair foreign practices such as the use of subsidies benefitting exports and foreign dumping. This Administration will continue to actively enforce our trade laws, as cases are brought to us.

This Administration is very concerned about the impacts of market restrictions and foreign export subsidies on U.S. exports of agricultural products. We have succeeded in getting increased access for U.S. beef and citrus to the Japanese market. Also, in reaction to foreign subsidies, we have subsidized U.S exports of agricultural products to some individual markets such as Egypt to emphasize that our patience is wearing thin, and are working both bilaterally with the European Community and multilaterally in the GATT to get these subsidies removed.

However, we do not see a need for broad export subsidies for all U.S. exports, to "offset" the impact of the strong dollar. Such subsidies would be extremely costly to the Treasury at a time when we need to sharply reduce Government expenditures. They could spur foreign imposition of countervailing duties. And they could set off an escalation of disruptive competition among nations to subsidize their exports, which in the end would cancel one another out with no net benefit to any exporting country.

In conclusion, I would urge the Congress to resist pressures to respond to the widening of our trade deficit with measures which would be harmful to our own broader national welfare. While it is unfortunate that impacts of increased competitive pressures from foreign goods are not always as evenly distributed among our citizens as are the benefits of our non-inflationary recovery, we must remember that the deficit is, to a large extent, an indirect result of our success in revitalizing the American economy.

As economic recovery abroad catches up with our own, as developing countries come more fully to grips with their debt problems, and as the international adjustment process brings an exchange market response to diverging external positions among the major industrial countries, we expect the deficit to begin declining again over time. In addition, where there are restrictions on access by U.S. firms to foreign markets for goods, services, or capital, we will continue to press for a more open system.

Table 1

U.S. Trade Balance, 1977-1984*
($ Billions)

	1977-1982 Average	1982	1983	1984**
Exports	187	211	200	215
Imports	-217	-248	-261	-325
Balance	-30	- 36	-61	-110

* Trade data on balance of payments basis.
** Treasury projection for 1984.

Table 2

Shifts in U.S. Trade by
Country or Country Group, 1981-1983*
($ Billion)

	1981	1983	Shift
Trade with Mexico:			
U.S. Exports	18.2	9.1	-9.1
U.S. Imports	-13.8	-16.8	-3.0
Balance	4.4	-7.7	-12.1
Trade with Other non-OPEC LDCs:*			
U.S. Exports	49.7	46.4	- 3.3
U.S. Imports	-53.1	-60.4	- 7.3
Balance	- 3.5	-14.1	-10.6
Trade with Japan:			
U.S. Exports	21.8	21.7	-0.1
U.S. Imports	-37.6	-41.3	-3.7
Balance	-15.8	-19.6	-3.8
Trade with Other Industrial Countries:			
U.S. Exports	120.1	105.3	-14.8
U.S. Imports	-106.7	-113.0	- 6.3
Balance	13.4	-7.8	-21.1
Trade with East Europe			
U.S. Exports	4.4	2.9	- 1.5
U.S. Imports	- 1.6	- 1.4	0.2
Balance	2.9	1.5	- 1.3
Trade with OPEC			
U.S. Exports	21.1	15.1	- 5.9
U.S. Imports	- 49.9	- 25.2	24.7
Balance	- 28.8	- 10.0	18.8

*All data on balance of payments basis, except trade with "other non-OPEC LDCs" which is on roughly-comparable Census Customs-value basis.

TABLE 3

U.S. Trade and Current Account Balances, 1981-1983
($ Billion)

		1981	1983	Shift
Exports:	Agricultural	44.0	36.6	- 7.4
	Non-Agricultural	193.0	163.6	-29.4
Imports:	Oil	- 77.8	- 53.8	24.0
	Non-Oil	-187.3	-206.9	-19.7
TRADE BALANCE		- 28.1	- 60.6	-32.5
Net Investment Income		33.5	23.6	- 9.9
Other Net Services		6.1	4.8	- 1.3
Net Transfers		-6.9	- 8.6	- 1.7
NET INVISIBLES		32.7	19.8	-12.9
CURRENT ACCOUNT BALANCE		4.6	- 40.8	-45.4

Table 4

Shifts in U.S. Trade Balance, 1981-1984
($ Billion; Balance of Payments Signs)

	1981	1984	Change
Exports	237	215	- 22
Oil Imports	- 78	- 60	+ 18
Non-Oil Imports	-187	-265	- 78
TRADE BALANCE	- 28	-110	- 82
Trade Balance Excluding Oil Imports	50	- 50	-100

Estimates of Contributions to Shift in Trade Balance:

U.S. Cyclical Position	-25 to -30
International Debt Problem	-25 to -30
Dollar Appreciation	-25 to -100

Table 5

THE BALANCED NATURE OF THE CURRENT EXPANSION

As the table shows, the current expansion has been remarkably well balanced, rather than distorted by high interest rates as some had feared. Above-normal gains have been made in the interest-sensitive areas of spending on consumer durables such as autos and appliances, as well as in business capital spending and housing. The trade balance has been weak but exports have risen rather than remaining flat as in the first year of the average of previous expansions.

Distribution of Real GNP Growth During
the First Year of Expansion
(as percent of total)

	Average of five previous expansions	Current expansion
Consumer Spending	52.3	57.3
Durables	19.3	24.0
Business Capital Spending	7.6	21.9
Housing	15.2	16.6
Inventories	26.4	34.2
Federal Purchases	-2.8	-8.7
State and Local Purchases	7.5	0.8
Net Exports	-6.0	-21.9
Exports	0.6	4.5
Imports	-6.4	-26.5
Memo: Total growth in real GNP in percent	6.8	6.2

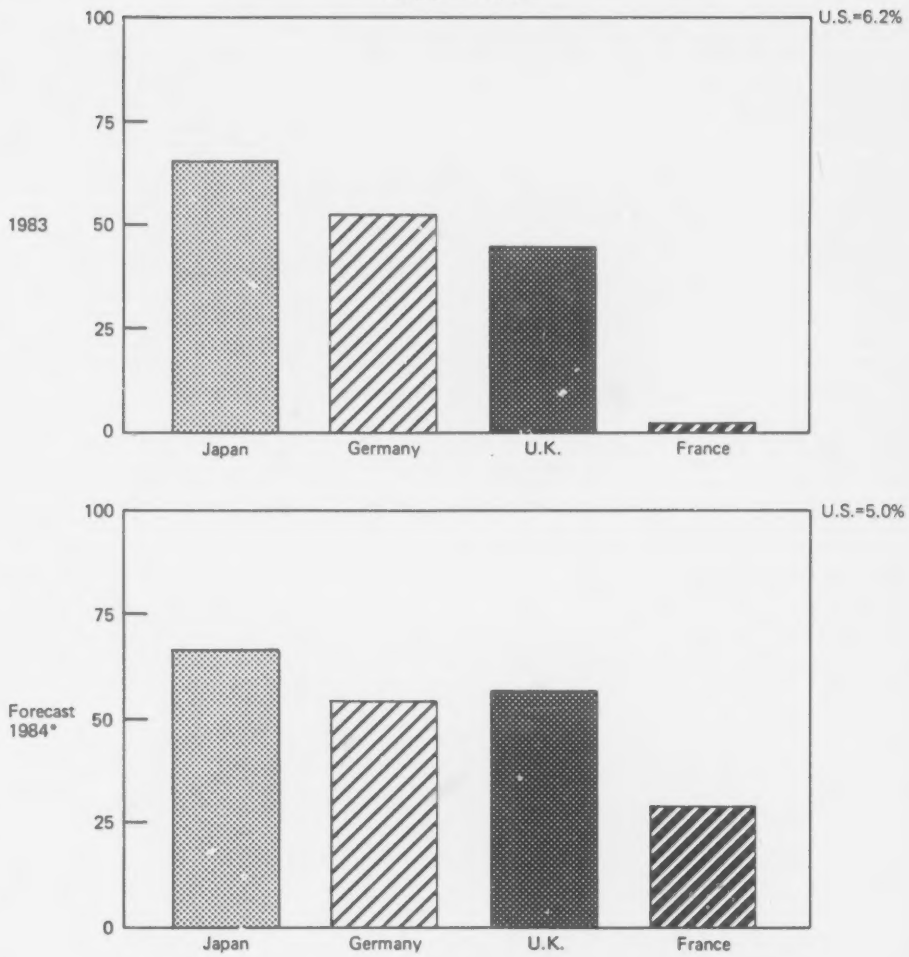
Table 6

U.S. Capital Account, 1982-1983
($ Billion)

	1982	1983
Recorded Inflows of Foreign Capital to U.S.	88	83
minus		
Recorded Flows of U.S. Capital to Other Countries	-118	- 49
equals		
Net Recorded Capital	- 30	34
plus		
Statistical Discrepancy	41	7
equals		
Net Recorded Capital plus Discrepancy	11	41
Current Account Deficit	-11	-41

Chart 1

REAL GROWTH RATES IN MAJOR FOREIGN COUNTRIES AS PERCENTAGE OF U.S. GROWTH, 1983—1984*



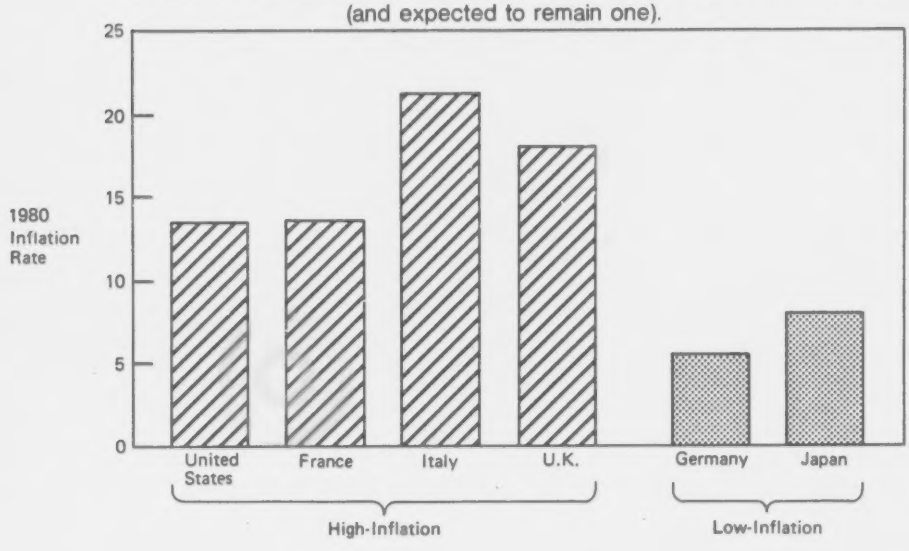
*Growth rates from fourth quarter to fourth quarter. 1984 forecast from FY 85 budget for U.S.; IMF World Economic Outlook for foreign.

Chart 2

INFLATION PERFORMANCE

UNITED STATES WAS HIGH-INFLATION COUNTRY IN 1980

(and expected to remain one).



UNITED STATES IS NOW A LOW-INFLATION COUNTRY.

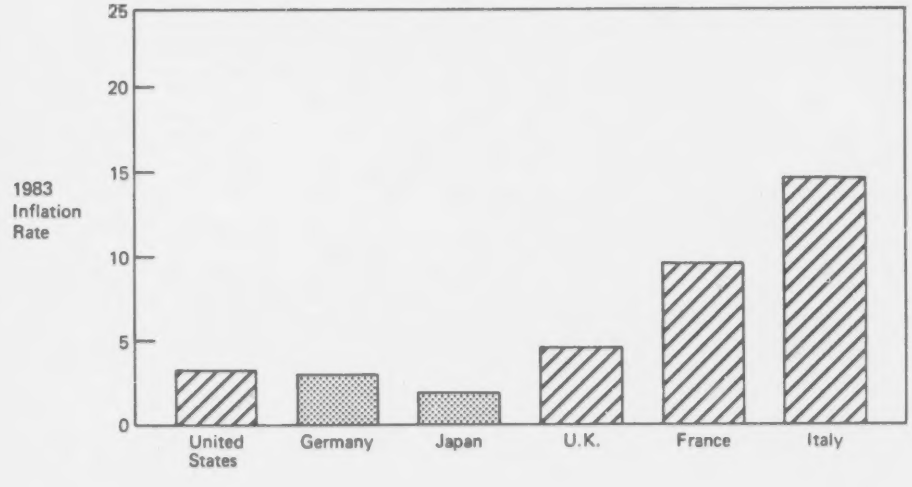


Chart 3

RELATIVE SUCCESS IN GENERATING EMPLOYMENT GROWTH

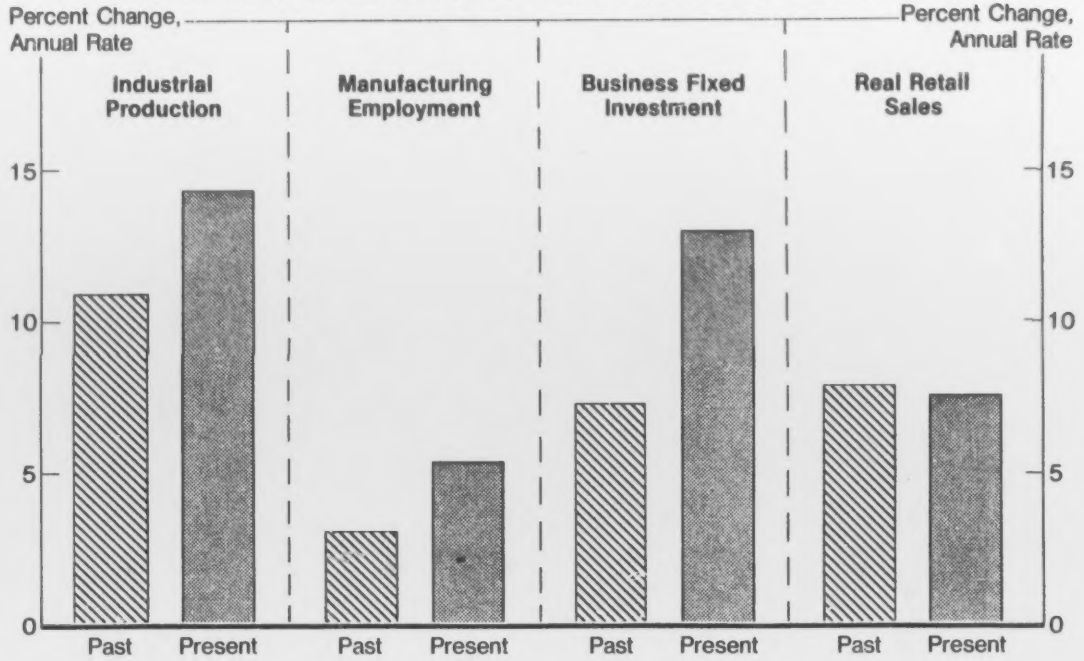
Increase in Civilian Employment
(millions of jobs)

	1970-1980	Since 1980*
United States	20.6	6.0
Japan	4.4	2.1
France	0.8	−0.1
Germany	−0.4	−1.2
U.K.	0.5	−1.4

* Data through May 1984 for U.S.; Q4 1983 for Germany; Q3 for U.K.; Q4 1982 for France.

Chart 4

COMPARISON OF THIS RECOVERY WITH PREVIOUS RECOVERIES*



*Post-Korean War recoveries excluding the short-lived 1980 recovery. First 17 months for industrial production and real retail sales, 18 months for manufacturing employment, and first 5 quarters for business fixed investment.

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Senator HEINZ. Secretary McNamar, let me commend you on a very comprehensive statement dealing with a variety of issues. I don't think that it serves the purposes of our subcommittee or the Government were you to oversimplify and give us a quick summation of some very complex issues. I commend you on dealing with these issues in some depth.

Just so that we all start off on the same foot, as I understand the position of the U.S. Treasury Department and from what Secretary Regan has said, is it fair to say that both you and he believe that real-interest rates are too high?

Mr. MCNAMAR. I think that real-interest rates are too high. If you look at the underlying rates of inflation that are anticipated in the next few years in the United States and in other industrialized countries and then you look at the current market rates, it seems to me that you can't equate the high real rates that we have. Let me say, though, that the measurement problems and how one accurately measures a real inflation rate provide some very serious theoretical questions about any kind of a statement on empirical evidence like that.

REAL-INTEREST RATES HURT THE ECONOMY

Senator HEINZ. I assume that one place and maybe the only place, for all I know, you and Dr. Feldstein would agree is that high-interest rates or high real-interest rates hurt the economy and that they pose not only a threat for the future but they are also causing some casualties to us right now, particularly in the more capital intensive industries. You would agree with that, I assume.

Mr. MCNAMAR. I wouldn't agree with it exactly as you stated it.

Senator HEINZ. If I quoted somebody else would it have been easier?

Mr. MCNAMAR. No, it wouldn't have been easier. I have a lot of respect for Marty. He's a superb economist and knows a great deal more about many things than I do. I don't always agree with his analysis or conclusions on every issue, however.

Senator HEINZ. We've noticed that.

Mr. MCNAMAR. I would agree with the statement that you made that real-interest rates appear unsustainably high; that is, I would not anticipate that they would continue at the current level that they are.

Senator HEINZ. I understand. I'm just trying to get you on the record as to whether, if they remain high, they pose a problem for the economy, or whether they hurt the economy at all right now, and whether there is a differential effect of today's real-interest rates on certain industries. Most people I have talked to, and I trust you won't be the exception, feel that, A, they are a problem over the long term, and B, certain industries are hurt by them, particularly those that have to make longer term investments. I know your background well enough to know you understand hurdle rates of return, and I thought this was a routine question.

Mr. MCNAMAR. It is, and the way you just stated it I agree with you.

Senator HEINZ. Thank you. I won't mention Marty's opinion then, but you just agreed with him. [Laughter.]

There is one puzzlement that I have with your analysis of our situation. In your excellent charts you have described a world where, the other countries, looking at themselves, and then looking at us, they see some very good things about us. They see low inflation, healthy job creation, political stability. Looking at themselves they see fewer jobs; depending on the country, inflationary conditions; depending on the country, tremendous to only moderate political uncertainty. They look at us and they see really an extraordinary economic performance, an extraordinary performance on inflation, and very few other safe havens around. Maybe if Japan, which you talked about at some length, permitted people to invest in the yen there would be one other safe haven besides the United States and Switzerland.

It typically happens, though, that when a country such as ours is doing very well and is perceived as a political safe haven that people want to put their capital in that country. People buy dollars now the way people used to buy Swiss francs, to such a degree that interest rates went down.

Indeed it seems to me that if everything you said was true and that people were beating a path to grab hold of the dollar, that the interest rates in this country would be much lower than they are today. If everybody wants to hold dollars and it becomes a seller's market, this will obviously lower interest rates. Why isn't that happening?

Mr. MCNAMAR. I can't give you an adequate answer to that question. Obviously as the demand for dollar denominated assets increases the laws of supply and demand do work.

Senator HEINZ. But the law of supply and demand works this way. The more people that want to hold dollars the more desire there is to purchase dollar securities.

Mr. MCNAMAR. I think it is dollar assets.

Senator HEINZ. Dollar assets. Thank you.

Mr. MCNAMAR. Farmland in Wisconsin or Illinois was very popular, for example, among a number of Middle Eastern investors during the late 1970's. That has created some problems today in the farm belt, quite frankly. We have seen demand for houses in California; we have seen a whole host of tangible assets as well as securities.

Senator HEINZ. You are absolutely correct. But let's stay with a fairly liquid set of capital flows, because I think most of them are reasonably liquid and we tend to talk about dollar denominated securities. What happens is that the people who sell those securities do not have to offer as high a return to the investor on them, in terms of pricing, as the interest rate, and the result is that a strong desire for dollar denominated securities should mean lower interest rates. If it was demand for dollars, that would be something different. But this is dollar securities.

Mr. MCNAMAR. I think there is a little bit more to it than that in that I think it is the anticipated aftertax real rate of return relative to the alternative investments in similar securities in Germany, Japan, Australia, or wherever. So if you have an investor who wants for the German metalworkers pension fund, for example, to hold a 10-year note—and I don't know whether pension funds in Germany are taxed or not—they would still be looking at the an-

ticipated aftertax real rate of return. So you have got the nominal rate of return, you've got the aftertax, and you've got the afterinflation rate or return, all other things being equal, relative to those other countries.

Senator HEINZ. But that is precisely the point. You have made the argument that all other things aren't equal. You've given an outstanding presentation to say, listen, the yield on your investments today in the United States, in Germany or any other country being equal, 99 times out of 100 any rational person will choose the United States. That's what you have said.

Mr. MCNAMAR. That's right.

BUDGET DEFICIT VERSUS HIGH-INTEREST RATES

Senator HEINZ. Under those circumstances we should be able to have interest rates that are lower than those other countries. Are interest rates lower?

Mr. MCNAMAR. No, our interest rates are not lower. Our nominal interest rates would be on the very high end of the countries that are, for example, at the London Economic Summit.

Senator HEINZ. That clearly leads me where you probably think it is leading me, which is to the budget deficit. I worry about the budget deficit because I am convinced it is increasing interest rates. You made the point that all the analyses that the Treasury Department has made do not show any correlation between budget deficits and high-interest rates. But what else is it? A plot by the bankers? It certainly isn't all the people who want to hold dollar securities. The people from overseas are working for lower U.S. interest rates because of the factors you just outlined. So who is doing it?

Mr. MCNAMAR. I would not agree with the statement that there is no correlation. That is an overstatement.

Senator HEINZ. Excuse me. I stand corrected.

Mr. MCNAMAR. I think the point that we would make is that we do not find a satisfactory correlation, and I can't tell you whether R square of 0.51 or 0.99 gives you satisfactory. I'll leave that to the statisticians.

Senator HEINZ. Which one did you get, 0.51 or 0.99? Or aren't you telling?

Mr. MCNAMAR. I don't recall, so I can't tell you.

The problem we have found is that people tend to take single variable regression analysis and they assume away such minor factors as monetary policy, they assume away such minor factors as demand for credit, they assume away a whole bunch of things. And you have got a whole host of data problems, you've got a whole host of analytical problems.

I just frankly think that to come up and delude the Congress with a simplistic answer when the real answer is "I can't give you a good one" is a mistake. It's a mistake to try to mislead you with a simplistic answer. I'm ashamed to come up here and give you a range estimate on dollar appreciation on the trade deficit being anywhere from $25–$100 billion, but when I am dealing with errors and omissions of $90 billion a year in the world's current account numbers I can't do any better than that.

I feel better about some of my other estimates there, and I feel the same way looking at the question of the deficit and interest rates.

Clearly Government spending does require Government borrowing; Government borrowing competes in the credit markets with private borrowing. No doubt about it. And the way that is ultimately reflected is in the price of that commodity, which is the interest rate. But I think the point is, is it the Government spending that is doing it or is it the deficit per se?

We could close the deficit by having an instantaneous tax right now that would raise the necessary revenue to close it. That would transfer those resources from the private sector to the public sector. It would mean that those resources would not be available in the private sector for individual decisions to make private investments, whether it's a farmer or whether it's anyone else, a factory worker or corporate executive. We could do that, but I suggest that that is not the way to solve the problem. The way to solve the problem is to work on continuing to try to reduce Government spending, to reduce the credit demands of the Government relative to the private sector.

In that connection I would point out—and again, this is the kind of analysis that I think one should provide to be more complete and honest—if you look at the countries that are at the London Summit, my recollection is that if you look at the public sector borrowing requirement, which is the broader definition—the British use that. And of course you know the difference in their structure, between their federal government and local government—if you look at that, my recollection is our public sector borrowing requirement is about 35 percent and theirs runs 45 percent, and virtually all of the other governments who are criticizing us for the size of our deficit have a higher public sector borrowing requirement on a combined basis.

Senator HEINZ. And we saw a moment ago just what that has gotten them in the way of net job creation, less than nowhere.

Mr. MCNAMAR. I would submit that is one of the factors, indeed.

Senator HEINZ. I would like to pursue this discussion but my time has expired.

Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman.

I would like to apologize for not being here at the start of this hearing, but I had to be on the Senate floor.

I am very pleased that the chairman of our Subcommittee on International Finance and Monetary Policy has scheduled hearings on the causes and effects of the cumulative appreciation of the dollar against the currencies of other major industrial nations and the adverse impact this has had on the competitive position of American industry.

Since 1981 the dollar has increased in value by almost 50 percent against a weighted average of the currencies of our major trade competitors. Such an exchange rate change is equivalent to foreign countries building new tariff walls against which our exporters

must compete. Our goods are much more expensive abroad and thus our exporters lose sales. Between 1981-83, for example, our exports of merchandise declined from $237-$200 billion. But the high value of the dollar is even worse than a new tariff wall, as our exporters do not have the protected home market they would have if there were reciprocal tariff increases. Because the dollar has appreciated in value foreign goods have become cheaper in our country, so our manufacturers lose domestic markets to foreign industry as well. Between 1982-83 imports to our country grew by $13 billion, and that trend is accelerating this year.

There is no doubt in my mind that the recent, rapid, appreciation in the value of the dollar is the principal reason for our huge, unprecedented and growing series of merchandise trade deficits. In 1981 that deficit was $28 billion; in 1982 it rose to $36 billion; in 1983 to $60 billion; and for the first 4 months of this year it was at an annual rate of $126 billion. This means that millions of Americans are losing jobs for reasons over which they have little personal control or even understanding. It makes no difference whether particular companies are well managed or workers disciplined and hard working—jobs and sales are still lost because of the dollar's high value. A not unexpected reaction by many industries and labor unions is to call for protectionist legislation. That, in my view, is not the proper solution to our trade problem, although if the current situation is not remedied it will be the one adopted by Congress. I also hear calls for new industrial policy schemes to be promoted by the Federal Government. I do not think that is the road for us to take.

I believe, and have said for some time, that the main cause of the overvalued dollar and our resulting trade deficit, can be found in our equally unprecedented budget deficits. To finance the massive $200 billion-plus annual budget deficits that we have had since 1981, the Government is borrowing nearly 75 percent of all our country's net savings. This drives up interest rates and leads foreign investors to sell their own currencies and buy dollars thus driving up the latter's value. So one solution to our trade deficit is to get our budget under control.

I am delighted that we have such a distinguished group of witnesses with us and look forward to hearing their analyses of and proposed solutions for our trade deficit. In particular I look forward to hearing Dr. Feldstein's views. I want to pay tribute to him for his distinguished service to our country over the past 2 years. I think he has been one voice in this administration who admits to the growing number of problems caused by our massive budget deficits. I regret seeing him leave Government and wish him well on his return to Harvard.

MASSIVE FEDERAL BUDGET DEFICITS

Mr. McNamar, I want to follow up on what the chairman has been asking you about on the massive Federal budget deficits we have.

Your prepared testimony seems to leave out, at least in my view, any strong connection between the Reagan administration's massive budget deficits, our high-interest rates, and the trade deficits.

You say that even if we didn't have the budget deficit, even if we tried to reduce it by increasing taxes, the implications of your response to the chairman are that it wouldn't have a favorable effect on interest rates, on the economy or on our trade deficit.

Ambassador Brock, this administration's chief trade negotiator, however does make the connection between our budget and trade deficits. On March 23 in testimony before the Finance Committee he said:

> The exact relation between the size of the Federal deficit and interest rates is subject to considerable debate. However, few would argue that Government borrowing to finance increasingly large deficits reduces interest rates. Reductions in future Federal deficits are essential to any improvement in our trade account.

Do you disagree with Ambassador Brock's analysis that the Federal deficit is the root cause of our trade problems?

Mr. MCNAMAR. I would say that if you would change that to Government spending I would be fully in agreement with that.

Senator PROXMIRE. Well, I think that the Reagan administration is just as weak on reducing Government spending. They sent up a budget with immense increases in spending. The priorities are different: they want a huge increase in military spending; they would hold down domestic spending. The Democrats are just as bad, because Democrats want to increase domestic spending and hold down military spending. The answer, it seems to me, is to hold down both. Obviously we are not going to do that. We should, but we won't.

So isn't the answer to hold down spending as much as we can and then make up the difference with as equitable a tax increase as we can engineer?

Mr. MCNAMAR. I certainly agree with you that we should hold down spending as much as we can, and I think that we need to have a number of things, one of which is a policy that will stimulate as much noninflationary growth in the private sector as we can, and that's a combination of both fiscal and monetary policy, as you recognize.

I think that you are also absolutely correct in that we need to take a look at the tax system, and we are in the process of that, to begin an effort to look at the tax system to see if we can't make it simpler, more fair and understandable.

For example, I think there are a whole host of things that are in the Tax Code that ought to be up for review, and the classic one—well, pick the Washington Post this morning. They had an article on the R&D tax credit. I think that ought to be a matter of debate as to whether it served our policies or not, whether it has promoted more R&D, promoted more growth, promoted more jobs. The same question of some of the real estate depreciation rules.

Senator PROXMIRE. Pardon me for interrupting, Mr. Secretary, but you have an administration that sent up to the Congress a budget that was $180 billion in deficits. That was the President's request. He modified that a little bit so it will be a little bit less, not much, in 1985. But this is the President's plan; this is his proposal; this is what he tells the Congress he wants. Can you really defend that?

Mr. MCNAMAR. I think we can defend that. First of all, you have to look at it as a proportion of GNP, and second, I think you have to look at it as a transition budget.

Senator PROXMIRE. As a proportion of GNP it's about 6½ percent higher than it has ever been at anytime in the peacetime history of this country. It has never been nearly as high as that. It is twice as high as it was in the depths of the Depression of the 1930's in proportion to GNP.

Mr. MCNAMAR. I don't think that is a comparable analog, quite frankly. I agree with you that the deficit needs to come down. I think the appropriate way to do it is through reducing spending, as you think, and I think that the package that was sent up and the proposals point to a path where it will come down as we move out of the recession, and some of the outlays that we had during the recession——

Senator PROXMIRE. You have to really believe in the tooth fairy and Santa Claus to believe that anything the administration has proposed now will really bring down the deficits. They forget all about the business cycle. They assume that 1985 and 1986 will continue to be years of growth. The fact is that 1985 will be the third year of recovery. On the basis of past experience we can expect either that the recovery is going to slow down quite a bit or that it may well move into recession. In either case the deficit is going to be substantially bigger, not smaller.

Mr. MCNAMAR. Not necessarily. I don't think that necessarily follows. We could close the budget deficit by going back to an inflationary policy, inflation of 10 or 12 percent a year. That increases nominal tax revenues substantially, and that reduces the nominal budget deficit, and we could do that. I don't think that is policy that you or anyone on the Senate Banking Committee, certainly, would advocate, and neither would the administration.

Senator PROXMIRE. Well, let me just indicate one other difference with the distinguished gentleman who preceded you as a witness. Unfortunately I couldn't be here. But he certainly has impressed many of us as a man of extraordinary honesty under very difficult circumstances. He said on March 23:

> The major cause of this year's increase in the trade deficit is due to the 50 percent rise in the real value of the dollar that has occurred since 1980. The appropriate remedy for the present trade deficit is to reduce the deficit in the Federal budget.

DOLLAR VALUE CAUSES TRADE DEFICIT

On page 8 of your testimony you say our widening trade deficit has been an unmitigated disaster although output and employment in our traded goods industries may be lower than they otherwise might have been. Doesn't that gloss over the fact that millions of American workers dependent on jobs in our export industries have lost their jobs because the high value of the dollar makes it difficult if not impossible for their companies to compete abroad and at home?

Mr. MCNAMAR. No, I don't think that follows. I don't know the exact quote you are using out of my testimony, but I think I said our trade deficit has not been an unmitigated disaster on page 8—

"Despite occasional assertions to the contrary, a widening U.S. trade deficit has not been an unmitigated disaster."

Senator PROXMIRE. You are correct. I thought I said "not," but perhaps I didn't. You are exactly right. My question is, it is certainly an unmitigated disaster to millions of Americans who have lost their jobs.

Mr. MCNAMAR. I don't think it's the trade deficit that caused millions of Americans to lose their jobs; I don't think it was the high dollar per se that caused that as any one factor.

Clearly one does get differential effects on the economy, and here I certainly agree with Marty, on various industries. The export-led industries have not done as well as we would like them to be doing at this point in time in the recovery. But I think that if you look at the question of whether we are having an unbalanced recovery or whether we are deindustrializing America or something, I think that the charts that I have submitted with the written testimony, particularly chart 4, point to the fact that in fact the recovery has been broad based, rather typical, better than most in some areas, a little bit behind in some others, and in terms, for example, of interest rates and the demand for credit, we have lagged the traditional increase in demand for credit and then have begun to accelerate very rapidly in the first quarter and second quarter of this year.

Senator PROXMIRE. The extraordinary thing about this recovery is that in spite of the perfectly colossal amount of pump priming and the enormous deficits that would normally stimulate the economy very, very greatly there hasn't been more of a recovery. We still have 8.5 million people out of work, still 7.5 percent of our work force out of work, as high as it was when the President took office.

Let me proceed. On page 3 of your testimony you say that the three major factors causing our widening trade deficits, which could well go over $100 billion this year, are, one, the strength and timing of the U.S. economic recovery; two, declines in our exports to debtor nations; and three, the appreciation of the dollar over the past 3 years.

Isn't it true that the latter two of these factors, that is, the declines in our exports to debtor nations and the appreciation of the dollar, are being made much worse by rising interest rates in this country?

Mr. MCNAMAR. No, I don't think that they necessarily are. On the dollar and the interest rates you have to again look at what interest rates you are talking about, and I think it is an incomplete analysis to simply look at nominal interest rates, which I think is what the question was predicated on.

For example, on the dollar question, if your hypothesis is that high nominal-interest rates cause a high dollar, that in fact would increase exports from LDC's into the United States and substantially help them reduce the LDC debt problem. In fact, you would find that the differential growth rate that we have had with our industrialized partners—for example, in 1983 and in 1984 we have accounted for probably 50 percent of the Japanese growth rate, maybe a little bit more in some instances, simply because they have been selling to us; and we have helped, through our trade deficit, to be sure, Germany, Japan the same way, France to a lesser

extent. I think that you cannot make the adequate causal links, and when I say adequate, I mean statistically satisfactory causal links.

Senator PROXMIRE. Maybe you can't make the causal link, but the head of the IMF has said that the No. 1 problem hindering world economic recovery is our series of Federal deficits which absorb so much capital from abroad, particularly from these small countries that so desperately and urgently need capital, driving their interest rates up, slowing their economy down, making it very hard for them to recover.

Mr. MCNAMAR. I am sure he was using that statement of the U.S. deficit as a shorthand for the discussion, the colloquy that the Chairman and I had, and what he really meant was the public sector borrowing requirement in the United States. As I pointed out, we are a little bit less than aggregate borrowing. I am sure you would agree that whether the State of Wisconsin, or California, or the Federal Government borrows a dollar from the credit market it has the same impact.

Senator PROXMIRE. Well, we are a very, very big factor in international finance, international trade. When we run a deficit of $200 billion, which dwarfs that of any other country in the world, and we borrow a great deal from other countries, it is bound to have an effect of increasing interest rates in other countries. It takes some of their capital, does it not?

FORECAST $177 BILLION DEFICIT

Mr. MCNAMAR. Well, yes and no. I don't believe anybody is suggesting the deficit is going to be $200 billion. I think the current forecast is somewhere in the neighborhood of $177 billion and some prospects perhaps of it being less and trending downward. But we have not seen an increase in the foreign purchase of U.S. Government securities during this period of time, which suggests that foreigners who are demanding dollars are not buying U.S. Treasury bills; they are buying something else; and this is typically through the interbank market, whether it's a CD of Continental Illinois, or Bank of America, or Citizens and Southern in Atlanta.

Senator PROXMIRE. That may well be true. The analysis may show that, but there is no question that the interest that has to be paid by our private sector borrowing is affected very seriously by this colossal amount of borrowing by the Federal Government. It increases the aggregate demand for credit and the price of credit, as you say, which is interest.

Mr. MCNAMAR. There are a lot of things that increase interest rates. Obviously demand is one of them. The new car sales, which as you know are up substantially, demand additional credit; flooring loans for dealers, consumer loans for purchasers; housing demand has rebounded. That has increased demand for credit. Commercial and industrial loan demands were virtually flat for about the first 15 months or so of this recovery.

Senator PROXMIRE. All that is healthy and all of this we applaud. We want to sell more cars, we want to sell more homes. The sale of homes is about what we should expect under normal circumstances in this country. It's about the replacement requirement that we

have. It's not at a recession level; it's at a reasonable level. But it is the enormous increase in Federal borrowing because of the colossal deficits, which is the one factor over which we have control, which is the one factor which, it seems to me, is most responsible. Obviously if we didn't have any demand for houses the rate of interest would be less; or automobiles.

My time is up.

IMPORTANCE OF INTERNATIONALIZING THE YEN

Senator HEINZ. Secretary McNamar, you touched on your efforts to internationalize the yen. Could you tell us why internationalizing the yen is so important?

Mr. MCNAMAR. I think there are a number of reasons, one of the first of which would be that Japan has had a controlled economy after the Second World War. They have used their financial institutions historically to try to keep money in Japan, channel credit toward national priorities. For example, they built an aluminum industry using subsidized credit in Japan, and it has been quite a controlled situation. They really can no longer have the advantages of the international trading system without bearing a commensurate responsibility in the international financial system. And that is really the underlying thrust.

They were about 6 percent of the OECD GNP in 1953; they are now 14 percent. And yet if you look at them as an official reserve currency, they are still running 3 percent. It really doesn't make any sense. They are 5 percent of the European market. Germany is 9 percent. They ought to be a currency that is used more in trade. Very, very little of their purchases are denominated in yen and a relatively small proportion of their exports are denominated in yen.

Senator HEINZ. I happen to agree with you, but why is that important to the average American? Let's talk in terms of our trade defict. What proportion of the U.S. trade deficit is attributable to our trade relationship with Japan?

Mr. MCNAMAR. Really very little directly with Japan. If you look at 1983, the trade deficit increased by about $24 billion, but the bilateral trade deficit with Japan only increased about $2.5 billion, probably 10 percent. But it is the third markets, and that is where I cannot give you an adequate measure.

Senator HEINZ. The trade deficit with Japan has been running at around $20 billion a year while our overall trade deficit was running at about $60 billion. If you accept the triple digit figure of $100-plus billion for this year and you look at the estimates I've seen of a $30 billion trade deficit with Japan, why wouldn't it be correct to say that our trade deficit is about one-third with Japan?

Second, why wouldn't it be correct to say that in fact Japan, because of its weak currency, is in fact our strongest competitor in the fields that really matter, particularly the ones for the future involving higher technology? Why wouldn't that be a good rationale for being concerned about the yen?

Mr. MCNAMAR. We are concerned, and that is a perfectly good rationale, and that is one of the additional motives that we had.

If I could draw an analogy that I think the Senator would be very familiar with, we face the problem in the United States in terms of deregulation of our capital markets, and the Senate in effect created the DIDC, the Deposit Institution Deregulation Committee, in 1980 to oversee that. In effect the Japanese are now beginning that same process, because they recognize that they don't have adequate investment opportunities at home for the capital that they are generating, and that is why they have been losing $20 billion a year, roughly, to us, among other places, and to the deutsche mark. I have no question that they are committed to this. They want to put behind them the past practices where I think—and I don't know the exact date, but let's say 1950 or perhaps even 1960—they did pursue policies to try to have an artificially low yen.

Senator HEINZ. They are not pursuing those policies now?

Mr. MCNAMAR. We can find no evidence that they are now, but there is still, with good historical reason, a lot of suspicion that they are.

Senator HEINZ. Are you suspicious that they are?

Mr. MCNAMAR. No, I'm not. And one of the reasons that I am not is because Japan is currently purchasing virtually all of their oil from the Middle East and other sources denominated in dollars, and beginning with October 1973 and again with the tripling of the price in October 1979 a weak yen hurts them in terms of how many additional yen they have to earn to buy a barrel of oil denominated in dollars.

Senator HEINZ. They have no barter arrangements?

Mr. MCNAMAR. I'm sure they have many barter arrangements.

Senator HEINZ. On oil?

Mr. MCNAMAR. I don't know what barter arrangements they have on oil. I'm sure they have some.

Senator HEINZ. To what extent is the yen currently undervalued? It's at what, 233 now?

Mr. MCNAMAR. It's about 230, I think it closed yesterday. I can't tell you that the yen is undervalued or is not undervalued. That is a market judgment based on all the factors that I have suggested.

I think that those who would take a rather crude or simple analysis and not try to take into account all of the factors I've indicated probably would not agree with me, but also I think they would ignore the fact that the yen in fact rose against the dollar in 1983 1.2 percent, about 16 percent against the deutsche mark, and it is up about a half a percent against the dollar since the beginning of the year. So that interestingly enough—and I wish Senator Proxmire were here to hear this—the increase in U.S. interest rates did not strengthen the dollar vis-a-vis the yen this year. That would suggest that those who say that it is simply the increase in U.S. interest rates strengthening the dollar vis-a-vis the yen are ignoring some other variables that they should take into account.

Senator HEINZ. Do you expect, though, as a result of the yen liberalization measures that you have been pressing on the Japanese——

Mr. MCNAMAR. Ruthlessly.

Senator HEINZ. I was looking for a suitably strong word.

Mr. MCNAMAR. That's it.

Senator HEINZ. That is a good characterization, having seen you in action at a few conferences. Do you think that the result of those measures will be to have the yen appreciate substantially?

Mr. MCNAMAR. I think that over time it will. I wish I could tell you what will happen in 1 year, what will happen in 3 years, and so on. I thought the Financial Times of London characterized it well when they said this is an excellent liberalization package but not quite the Magna Charta in terms of liberalization. I think that the long-term effects will clearly be to have the yen higher than it would have been vis-a-vis the dollar, putting aside the other factors that might influence it.

Senator HEINZ. Is Japan protectionist generally?

JAPAN MOVING AWAY FROM PROTECTIONIST POLICY

Mr. MCNAMAR. I think that they are moving in the direction of liberalization of virtually all of their trade from a basis that I would characterize as protectionist, yes.

Senator HEINZ. Thank you.

In the time we have left I would like to turn to the international debt issue which you have been much involved with over the last year or two. Is it accurate that now that the United States is a significant importer of capital, $30 or $40 billion this last year, an expected $60, or $70, or $80 billion this year, that the LDC's have become net transferors of capital funds to us?

Mr. MCNAMAR. No, I don't think that is the case.

Senator HEINZ. Well, let me be more specific. Is it accurate that the interest they are paying the creditors, which includes us and other developed nations, is in the neighborhood of $50 billion a year and that the new loans going to the LDC's are in the neighborhood of $25 billion a year? And if that is accurate, aren't we coming out ahead in terms of capital flows in the neighborhood of 2 to 1?

Mr. MCNAMAR. I think there are a number of factors that influence that.

Senator HEINZ. Are the statistics accurate?

Mr. MCNAMAR. No. For example, you have to look at loan commitments versus funded loans, and the first assertion, that the United States had become a net importer of capital, was a BIS study that was released in February on loan data, I believe, for the second and third quarters of 1983. And they were quite correct in that there were not funded loans, which is the basis that they use, at that point in time, and the reason is Mexico and Brazil were in the process of negotiating packages but didn't fund anything right there, and that alone would have been enough to take it negative, I believe.

I think the concern is this is a situation that is going to continue if you took the funded loans basis. For example, Mexico. As you saw in the papers this morning, there is a general consensus that Mexico is going to move to a multiple year rescheduling, that their economic performance is excellent. They have, I believe, no net new need for money next year, which would exacerbate the problem in that the United States would not have outflows increasing to Mexico. And in addition, if they go to multiple year rescheduling

with a substantial grace period, that would reduce the inflows to the United States and others.

So I think you have to look at the longer term trend there. But I am not concerned, quite frankly.

Senator HEINZ. There have been some suggestions among the debtor nations that interest rates should be capped to the high debt LDC's. What do you think of that idea?

Mr. MCNAMAR. I have never seen a paper on it, because I've never seen anyone that has really thought about this problem propose this idea. A few dilettantes and people have made this. I regard it as almost a naive suggestion, at least in the formulations I have heard to date.

Senator HEINZ. Apart from that you don't object to it at all?

Mr. MCNAMAR. How could I come up here, assuming that I would be someone this committee might call to testify, and justify that and not justify capping loans to the steel industry in Pennsylvania or to the dairy farmers in Wisconsin?

Senator HEINZ. Careful.

Mr. MCNAMAR. It would seem to me that would have some questionable imbalance, and I think that that would be an intrusion in private credit decisions that the Government should be loathe to rush into. So I frankly think that people who have suggested that really have not thought through the implications, and indeed I think some international bankers who espouse the idea and have touted it a bit have been a little dismayed when they talk to either their chairmen or the domestic credit side of their banks. So I think it is an idea whose time has not yet come.

Senator HEINZ. I am advised by staff that the dilettantes who said we should consider capping interest rates are Tony Solomon and Paul Volcker.

Mr. MCNAMAR. I don't think Paul Volcker had said that.

Senator HEINZ. I am responding to information hot off the note pad. [Laughter.]

I cannot personally vouch for the accuracy, although we will have a serious conversation with staff later. [Laughter.]

Mr. MCNAMAR. Let me defend staff and set the record straight. I had the same reaction when I read a story, front page, column 1, in the Wall Street Journal, which indicated that Paul had said that down at the Business Council on a Sunday morning. It ruined breakfast for me. When I read the Washington Post and I found that Hobart Rowen had written a comparable story, inside, last paragraph, with a vague allusion, it suggested to me there was an inconsistency there somewhere, and I took occasion to call Paul that evening when he returned, and in my usual gentlemanly fashion asked him what he had said. He was astonished at that story and subsequently took the liberty of sending around the transcript of his press conference, which made it quite clear that he did not endorse interest rate caps.

Senator HEINZ. Well, now you have cleared up something that was of some concern to some of us up here.

Let me ask you one other related question. We all agree that the dollar is strong. We can attribute it to different reasons. I suspect I attribute it more to high interest rates, and therefore the budget deficit, than you do. But irrespective of those reasons, are the

strong dollar and what you obviously perceive as a problem, the relative high interest rates, hurting the LDC's that owe us so much money?

Mr. McNAMAR. It is a mixed blessing and curse as far as they are concerned. The interest rates are hurting, yes. No question about that. And that underlies these ideas of capping or variable interest rates, and there are schemes there that perhaps subsequently people will find acceptable. But again, these countries tend to have their currencies pegged to the dollar and in their devaluation decisions tend to look at both the dollar and their internal inflation rate, and the increase in the dollar relative to their currencies makes their exports substantially cheaper here, and that promotes their exports.

Senator HEINZ. Are they coming out ahead or behind on that?

Mr. McNAMAR. A number that I saw—and I can't verify it, but I will tell you the source, and I have no reason to doubt the source—a number that was given in a speech by Ambassador Mittendorf to the OAS talked about this particular tradeoff, which I think is the right question, in Brazil. I think he came out that the Brazilians were 4 to 1 ahead. If you look at the increase in demand in the U.S. economy, the increase in Brazilian exports to the United States, and the strong U.S. economy creating the demand for credit here, increasing the interest rates, which increase the payout from Brazil, what is that tradeoff between increased incremental exports and incremental payments on the debt. And I think he came out with about a 4 to 1 advantage for Brazil.

I would be glad to supply that for the record, Mr. Chairman.

Senator HEINZ. I would appreciate that.

[The following information was subsequently supplied for the record:]

Requested Insert for the record of the Hearings which included Deputy Secretary McNamar's testimony of June 6, 1984.

Treasury Department staff has calculated, based on data available in early June, that the beneficial effect to the non-OPEC LDCs as a whole from stronger imports by industrial countries could outweigh by a significant margin the impact of higher interest rates. For a 12-month increase of 1 percentage point in interest rates, the non-OPEC LDCs as a whole (excluding all European countries) would face increased gross interest payments on variable interest rate debt of about $3 3/4 billion during the next year. However, these same countries had substantial deposits in external commercial banks which could earn roughly $1 1/4 billion in additional interest receipts. Thus, the net impact on an annual basis would be about $2 1/2 billion for each one percentage point increase in interest rates. Since the beginning of the year, interest rates (London Inter-bank Offer Rate or LIBOR) have increased about 2 1/4 percentage points, which, were they to remain at those levels, would imply a full year net interest cost of about $5 3/4 billion.

However, industrial country imports from the non-OPEC LDCs rose in the first part of 1984 at rates which, if continued through the rest of the year, would increase LDC export revenue by a multiple of the increase in interest costs thus far in 1984. For example, U.S. imports from the non-OPEC LDCs were up $8.4 billion (36%) in the first four months of 1984 compared to the same period of 1983. Although recovery in other industrial countries has proceeded more slowly than the U.S., industrial country imports from the non-OPEC LDCs were up about 20 percent in the first quarter (based on partial data) over the same period of 1983, equivalent to more than a $25 billion annual rate.

Senator HEINZ. Tim, thank you very much for addressing so many subjects.

SLOW GROWTH IN INVESTMENT FOR EQUIPMENT

I guess I have one final question for you regarding the extent to which our high-interest rates are prejudicing, both now and even more importantly for the future, capital goods industries in this country. The analysis that I have seen is that net investment by U.S. business is running at an extraordinarily low rate of growth relative to historical trends; that it is running at only two-thirds or less historical averages. I am talking about net investment, which is to say the replacement of worn out plant and equipment. Apparently one of the reasons that we are having problems is that investment horizons are so short that we are not investing in any long-lived equipment. We are investing in short-lived equipment, which wears itself out very quickly, becomes obsolete very quickly, and while a lot of money may be spent, it is not buying what it previously bought, and therefore net business investment is performing poorly.

Is that your understanding?

Mr. MCNAMAR. I don't think that is my understanding.

Senator HEINZ. I will submit the details to you for consideration by the Treasury Department. Frankly, I urge you to focus on this problem.

Mr. MCNAMAR. We would like to focus on this problem in the tax reform hearings that we are having and to explore it with you, because what we see is that the capital spending looks about like you would expect it to. But there is clearly a higher proportion of imported goods, machine tools, with which you are familiar, being a classic example, than domestic even though machine tool orders for domestic manufacturers are up tremendously.

Senator HEINZ. That's right. But we are importing about 300 percent more from abroad than we traditionally have.

Mr. MCNAMAR. That's right. I think that as we see the factory work week extending, and I think it's at its highest level now since the mid-1960's, as we see at this point in the economy production and capacity beginning to bump up to capacity that may still be on the books but de facto is obsolete because it is uneconomic to manufacture, given the anticipated price rises, I think you are going to see new increments of capital investment going in.

Senator HEINZ. Either that or we'll see inflation.

Mr. MCNAMAR. Or you'll see inflation.

Senator HEINZ. And the question is, are interest rates going to be so high that they cause inflation by making it unattractive to invest in expansion of capacity? The big problem, as you point out, is we have not been investing in expanded capacity; we have been investing to some extent in a lower unit costs, but those kind of investments are fairly short term.

Mr. MCNAMAR. That's right.

Senator HEINZ. One of the concerns I have about the current economic expansion, for the reasons also you just described, is that normally at this point the capital goods sector expansion, which are yet to experience in any major way, continues to propel eco-

nomic expansion. Because of the high proportion of imports which you mentioned, we are not getting that kind of boost, and I worry that we are going to run out of gas.

Mr. MCNAMAR. I share that concern. But let me just suggest that there is a statistical anomaly in there in that the relatively strong dollar which has produced the increase in imports of capital goods, that we in fact have held down the prices of capital goods, and because the prices haven't risen so rapidly the nominal percentage increase that gets reported is therefore not as large as it would have appeared. Ultimately that is a good thing.

Senator HEINZ. Lower prices are good as long as everybody doesn't go bankrupt because of them. Check with the farmers. They will explain this to you.

Mr. MCNAMAR. I accept that.

Senator HEINZ. Very well.

Tim, I thank you very much for your responsiveness to all our questions. We appreciate your testimony. Thank you very much.

Mr. MCNAMAR. Thank you.

Senator HEINZ. The panel of witnesses that are taking their place at the table, include the Honorable—or formerly honorable—Fred Bergsten. [Laughter.]

Mr. BERGSTEN. Once honorable, always honorable, Mr. Chairman. [Laughter.]

Senator HEINZ. Mr. Robert Heller is here, as is Allan Mendelowitz of the General Accounting Office, who has been before Congress on a number of occasions to tell us about his fascinating findings.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Senator HEINZ. Let me ask Fred Bergsten, currently the Director of the Institute for International Economics, to be our leadoff witness.

Mr. BERGSTEN. Mr. Chairman, I have given you an extensive statement for the record, and so I will summarize it briefly, sticking to the first four or five pages, in which I try to summarize a good bit of my analysis.

I did not hear Marty Feldstein's complete testimony this morning, but having gone on a number of programs with him in the last few months on this topic, I think I know pretty well what he said, and my analysis, in large part, parallels his. So I won't repeat things that I know he said, and will simply emphasize a few differences and additions, particularly at the level of what needs to be done about the problem.

HORRENDOUS TRADE DEFICIT

My first basic point is that the difficult trade and international financial position that we face is even worse than most people realize. I say that for several reason. First, the numbers themselves. In 1984, it now seems clear that the merchandise trade deficit will hit at least $125 billion and the current account deficit, not the $60–$80 that you and others have been referring to this morning, but about $100 billion. We are well on the track to that already with

the results of the first 4 months. The deficit is rising at a dramatic pace and, unfortunately, I think it will continue to rise.

I've had the nerve, perhaps, to project out to 1985. I'm afraid that in 1985, the merchandise deficit will hit about $150 billion on current trends. That takes the current account to about $125 billion.

I would say only in defense of these numbers, that may sound high to you, that I was probably 2 years ahead of anybody else in accurately projecting that the deficits were going to hit $100 billion or more. I began saying that in late 1981. All too unfortunately, it came true, and I am afraid there continues to be a tendency to underestimate how bad these numbers are.

What, in a sense, is even worse than the horrible numbers per se is that there is no turnaround in sight in the continuing deterioration. The dollar has continued to hit new highs in the exchange markets, indeed, hitting a new trade-weighted high only 3 weeks ago. The United States looks like its continuing to grow faster than the other major countries, thereby sucking in more imports than our foreign markets can absorb U.S. exports. So reversal of the steady deterioration is not in sight, let alone a return to tolerable levels on the trade and current account numbers.

Beyond that comes the job effect that you, Mr. Chairman, have referred to. By this time next year, probably 3 million Americans in the export and import competing industries will have lost their jobs or lost job opportunities because of this enormous deterioration in our trade balance. Even that, I think, might be a conservative estimate, because we now use a lower coefficient for relating trade balance loss to jobs than we once did.

Senator HEINZ. Excuse me. Is that 3 million from today?

Mr. BERGSTEN. No, that's from the start of the deterioration in the trade position, which dates from early 1981. It's over a period of 3 to 4 years. To me that's the relevant comparison. You go back to a period when our current account was roughly in balance, 1980 and the early part of 1981. The deterioration has been steady over the 3-plus years since that time, and that's the period that I address in most of my analysis.

UNITED STATES IS BECOMING A NET DEBTOR NATION

The next implication, which is worse than people think, is not only that the United States is becoming a net debtor country, that is with more foreign asset here than U.S. assets abroad, but that by sometime in 1986, almost assuredly, we will approach the present debt level of Mexico and Brazil in absolute terms, namely, net debtors on the order of about $100 billion a year, and since this can't turn around very fast, if at all, in the next 2 or 3 years, our net debtor position is clearly going to soar beyond that of Mexico and Brazil up into several hundreds of billions of dollars, making even our debt/export ratio and our debt/GNP ratio approach those of some of the debtor countries whose policies and positions we deplore today.

There is also a very practical effect of all that. As recently as 1982, we were a net creditor country on the order of a couple of hundred billion dollars. That means we were earning something

like $30–$35 billion a year on our foreign investment. Now we will not only be losing those earnings, we will start to be a net payer as our debtor position becomes a negative and grows so substantially. That takes real earnings, real income, real wealth away from our economy, and requires an even bigger improvement in our merchandise trade to get back to any concept of current account equilibrium. It therefore means that we pay the piper later for the profligacy that is now going on.

It is stunning to note, Mr. Chairman, that in only 3 years we will have reversed totally the buildup in international investment that this country accumulated over 65 years. It's a stunning change. It's the international equipment of the fact that the domestic debt that was accumulated in the first two centuries doubles in 5 years. The foreign equivalent is that the buildup of 65 years is thrown away in 3, and indeed, reversed.

The main cause of all this is clearly the massive overvaluation of the dollar in the exchange market. As I mentioned, the dollar just in the last 3 weeks has hit new trade-weighted highs. Depending on what index you use, it's up by 30–40 percent from the middle of 1980, and is overvalued by at least, underline at least, 25 percent.

Tim McNamar said in his chart presentation he was very uncertain, within a wide range, of how much the overvalued dollar was contributing to the dollar. On my analysis, which has been carefully put together, something like two-thirds to three-quarters of the deterioration from early 1981 is due to the sharp rise and overvaluation of the dollar.

I would also say that Secretary McNamar's criticisms of this kind of analysis are a bit unfair. He referred to simplistic purchasing power parity analysis. Indeed, I agree that many of those are simplistic. It is for exactly that reason that my Institute for International Economics, in a publication that we released last September, took a new approach to the problem, a much more sophisticated approach, one which is not without some difficulties itself but is certainly not simplistic purchasing power parity, and I think went much further than previous analyses in suggesting how one can calculate the overvaluation. We concluded that it is now about 25 percent, if not more.

The dollar overvaluation, it seems to me, has created most of this massive trade deficit. Beyond that, it has a couple of other negative effects. It certainly adds to the pressures for trade protection that you and your colleagues get here on the Hill. It is a fact that all American exporters are now facing the equivalent of a tax of 25 percent or more on everything they sell abroad, and that all American import competing industries are facing the equivalent of a subsidy of 25 percent or more on everything that is being brought into the country from abroad, and so it is difficult for them to compete. They react in the natural way, looking for direct recompense against that import competition and seek to subsidize their exports as well.

Trade protection during the postwar period has clearly correlated in this country more with dollar overvaluation than unemployment or any other variable, and that pressure is going to continue to build on you, as the deficit soars, if the dollar stays overvalued.

Furthermore, and this is a point you raised directly in the earlier part of the hearing this morning, is the effect on investment in the United States. It's not only the direct impact of high interest rates, it's also the effect of high interest rates working through the overvalued dollar. I am hearing now from an increasing number of American firms in major industries a real question as to whether they should put up new plant and capacity in the United States, given the fear that this dollar overvaluation could continue.

MULTINATIONALS SHIFTING TO FOREIGN AFFILIATES

We have seen already with dollar overvaluation of the last 3 years, many American multinationals dramatically shifting their sourcing of sales from their U.S. base to their foreign subsidiaries and affiliates. Some major multinationals testified that, whereas they traditionally sourced 60 United States, 40 percent abroad, they have reversed that ratio. They have had to shift sharply to their existing offshore affiliates. In fact, a shift of that magnitude generalized to all American multinationals would explain the totality of the deterioration of our trade balance. But then comes the next question: Beyond using your existing plant, when you start to bump up against capacity limits and you need to put up new capacity to serve market growth, where do you put it up?

If you fear continued uncompetitive pricing out of the United States, you may be forced to put up that plant abroad. Once that is done, of course, that production, those jobs are lost for the indefinite future.

That, I think, is the risk of deindustrialization of our economy, if indeed there is one today. That, it seems to me, is much more important than Japan, Inc., or level playing fields for trade barriers. Those things are important, but they're swamped in quantitative impact by this enormous cost of pricing ourselves out of world markets by the dollar.

Finally, what to do about it. I fully agree with you, Mr. Chairman, that by far the most important issue is to get the budget deficit down substantially, credibly, and quickly. That, in turn, will bring interest rates down, which, in turn, will help correct the dollar over the long run. In a sense, it's a little irrelevant to argue, as Secretary McNamar did, that there are all sorts of factors that go into the equation. Sure, there are all sorts of factors that go into the equation, but none of us is going to undermine the safe haven appeal of the United States, if we can help it. None of us is going to slow down the growth rate in order to strengthen the dollar.

The issue is, what can we do something about through sensible policy that will correct the dollar overvaluation? And the obvious answer is interest rates, and that gets back to the budget deficit. So it seems to me clearly in policy terms that is the issue. That's what one can affect, where one ought to be making every effort.

However, I don't think one can just stop there, because there is sufficient risk that you here in the Congress and the administration will not take enough action, quickly enough, to avoid continued deterioration and also these enormous costs of dollar overvaluation. And therefore, one has to go to what economists think of, and don't like to talk about too much, a second-best policy.

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POSSIBLE SOLUTIONS

What can you do in a world that is messy and second best, or do you just sit back? The administration has basically said, sit back, and do nothing. I think the costs are too high, and there are some things that can be done. One is to intervene directly in the exchange markets themselves. I am not a believer—and I had a lot of experience in it in my Treasury in the late 1970's—that intervention per se can turn the exchange markets or fundamental trends, but you do get periods, and we've had two or three in the last 18 months, when market forces themselves are moving in the right direction. The yen has moved up, the deutsche mark has moved up, the dollar has come off.

Joint intervention, moving with those periods of corrective movement can strengthen, prolong and push those movements in the correct direction to a significant extent. In short, one should have the central banks leaning with the wind of market movement, when the wind is moving in the direction of underlying equilibrium. I use those terms because the conventional approach is to lean against the wind to try to limit volatility in the markets. That may be OK in some situations, but when the market itself is moving toward the right direction, I think one can come in and promote it and do so in an effective way.

Beyond that, it may be that one has to intervene directly to influence the capital flows, which are swamping the trade and current account positions.

This would be easily done, for example, in the Japanese case. Indeed, when President Reagan visited Tokyo in November, the Japanese agreed to take an important step in that direction, to borrow heavily abroad—borrow dollars, deutsche marks, and the like, convert the proceeds into yen to strengthen the yen in the exchange market, so-called Nakasone bonds like the Carter bonds that we floated in the late 1970's to strengthen the dollar. And those, of course, worked effectively.

Unfortunately, that seems to have been completely forgotten—forgotten by the Japanese, who've done only $100 million, which is a pittance of those bonds, and forgotten by the Treasury, which in its zeal to promote the liberalization of the Japanese capital market that was so proudly discussed earlier this morning, forgot about the measures that could have the most immediate and positive impact on correcting the yen/dollar misalignment. Indeed, it's my judgment that the yen agreement that was reached and announced with such fanfare last week makes the trade problem worse. The reason is that liberalization of the Japanese capital markets, at least in the sort run, means more capital outflow from Japan, because the remaining barriers in Japan mainly limit the outflow of capital, not the inflow. And so in the short run, it's going to make it worse.

For the longer run, I've studied a great deal the evolution of national currencies and international finance and what you learn is that greater international use of a currency increases its volatility over time, but does not change the underlying trend. It is probably true, as the Deputy Secretary said, that in some periods you'll get a stronger yen as people are building up yen balances. But once

those balances are built up, it's an overhang that can be sold off. When it's sold off in periods of subsequent underlying weakness in Japan, the yen will be weaker than otherwise would be the case. Over time, history suggests it would tend to net out.

The deutsche mark right now is so weak against the dollar and against the yen, in part because the deutsche mark became an international currency in the late 1970's. People built up their deutsche mark balances. That pushed the mark to an overvalued level, but now the selloff of those same balances has helped push the deutsche mark to an undervalued and weaker level.

So there is no reason even in the longer run to think that what's been done recently is going to help the situation. In short, there are things one can do in the capital market, but they have not chosen to do them so far.

Finally, on one point I certainly agree with Secretary McNamar. It would be a mistake to apply import controls to try to deal with the trade balance problem. Indeed, putting on an import surcharge or new import import controls would tend to strengthen the dollar further in the exchange market. It would thereby offset any gain to our trade balance, sock our exporters even worse and probably make the long-run situation even more difficult.

So on that I would agree. Other than that, I think we've got a major problem. It's getting worse. There's no turnaround in sight and measures had better be taken and are available to deal with it.

Senator HEINZ. Fred, thank you very much.

[The complete statement follows:]

THE UNITED STATES TRADE DEFICIT AND THE DOLLAR

Statement by C. Fred Bergsten
Director
Institute for International Economics

Before the
Subcommittee on International Finance and Monetary Policy
Senate Committee on Banking, Housing and Urban Affairs
June 6, 1984

Summary

The outlook for the international trade (and financial) position of the United States is shocking:

-- In 1984, the merchandise trade deficit will probably hit $125 billion and the current account deficit could exceed $100 billion. The trade deficit for the first four months of the year has already soared to an annual rate of almost $115 billion, and is rising at a dramatic pace.

-- In 1985, the trade deficit could reach $150 billion and the current account deficit about $125 billion. No reversal of the steady deterioration of the past three years, let alone a return to tolerable levels for the deficit, is in sight.

-- As many as three million Americans in export and import-competing industries will be unemployed by late 1985 as a result of this deterioration in our external accounts.

-- In addition, as a result of the huge net capital inflows needed to finance these deficits, the United States by

1986 will clearly owe more to foreign nations than the value of its own investments abroad--becoming a net debtor nation for the first time since World War I, and approaching the present debt level of Mexico and Brazil in absolute terms.

-- This reversal of America's international investment position will eliminate much or all of the annual net inflow of investment income to the United States, which peaked at over $33 billion in 1981 and has been a major source of strength of our current account for decades. The elimination of our surplus on services transactions will require an even greater improvement in the merchandise trade balance to restore current account equilibrium.

-- The main cause of these problems is the massive overvaluation of the dollar. The dollar has just hit new trade-weighted highs, up 30-40 percent (depending on the index used) from mid-1980, and is overvalued by at least 25 percent.

-- In addition to causing most of the huge trade deficits, continued dollar overvaluation is a major source of pressure for trade protection measures. More and more American firms are finding themselves unable to compete when saddled with the equivalent of a 25 percent tax on all exports and payment of a 25 percent subsidy to all imports.

-- Moreover, the specter of continuing dollar overvaluation is inducing major US firms to contemplate investment abroad rather than at home, as occurred during the last major period of dollar overvaluation (late 1960s - early 1970s), with the attendant risk of substantial deindustrialization of our economy.

-- To assure lasting and stable dollar correction, urgent action is needed to substantially reduce the budget deficit and thus US interest rates--which draw large amounts of capital into the dollar. (The short-run impact of budget action might be to strengthen the dollar, and failure to deal decisively with the budget might lead to a precipitate and excessive fall in the currency, but orderly dollar correction is possible only via orderly restoration of a viable mix of fiscal and monetary policies on the United States.)

-- To help correct the currency misalignment, the monetary authorities of the United States and other major countries should also intervene jointly in the exchange markets to sustain and accelerate the strengthening of the yen and European currencies that occur periodically, most recently during February and early March (as in late 1982 and fall 1983). In such circumstances, the authorities should replace the traditional intervention criterion of "leaning against the wind" to "lean with the wind" when it is blowing in the direction of underlying equilibrium. Absent such interaction, all

these corrective movements stalled out and subsequently were reversed.

-- In the absence of such steps, and perhaps even in addition, direct action to alter international capital flows may be needed. As other nations share the US interest in correcting the currency misalignment, the most feasible remedy is probably for the weak-currency countries to borrow heavily abroad ("Nakasone bonds" in the case of Japan) to promote capital inflows and, if necessary, to install interest equalization taxes or limit their capital outflows temporarily through direct controls (in Japan, perhaps via using "administrative guidance" as in 1979-80 to curb for a while the massive foreign investments of the insurance companies and other large institutional investors). By contrast, the recently announced US-Japan "yen agreement" will make the problem worse, at least in the short run, by encouraging more capital outflow from Japan.

-- It would be a mistake to apply an import surcharge or other import controls as a corrective device. Under floating exchange rates, such steps could be expected to lead to a further strengthening of the dollar--which would offset the gains from the surcharge, in large part by driving US exports down even further--in response to market expectations of a resulting improvement in the trade balance. In addition, any such act by the United States--the only industrial country in the world which

has recovered rapidly from the recession and where unemployment is falling sharply--would clearly trigger major retaliation from abroad, perhaps destroying the relatively open trading system and detonating the "debt bomb" by denying the expanded export opportunities which are the only means by which many developing countries can hope to keep servicing their external liabilities and restore at least a modicum of growth in their domestic economies.

The Trade Outlook for 1984 and 1985

The US merchandise trade deficit has been deteriorating steadily since early 1981. In 1981-82, the decline in real net exports accounted for 75 percent of the total decline in the economy and was by far the biggest cause of the recession. For the year 1983 as a whole, the deterioration in real net exports of goods and services retarded the recovery by a full 25 percent--bringing it in at 3.3 percent rather than the 4.4 percent (year-over-year) which would have occurred with an unchanged trade balance.

In 1984, substantial continued deterioration can be clearly observed. The deficit hit an annual rate of about $115 billion for the first four months of the year, up dramatically from the rate of $75 billion in the fourth quarter of 1983. The most important cause of the problem is the overvalued dollar which continues to reach new highs in the exchange markets--hitting a new peak, on the Commerce Department index, on May 18. The dollar is now overvalued, relative to underlying competitive

positions, by about 25 percent.[1] This is the equivalent of placing a 25 percent tax on all US exports and paying a subsidy of 25 percent on all imports coming into the United States.

Every percentage point deterioration in US price competitiveness costs our trade balance $2-3 billion over the coming 1-2 years. Hence the rise of 30-40 percent (depending on which index is used) in the trade weighted value of the dollar from mid-1980 until now could be expected, by itself, to produce a rise of $60-120 billion in the US trade deficit. In fact, this year's deficit will represent a deterioration of about $100 billion from 1980-81, and the 1985 level will be about $125 billion higher than 1980-81.

There are other factors, as well, pushing the US trade deficit to these record levels. The United States seems likely to continue growing faster than all other major countries in 1984 (for an unprecedented second straight year). DRI projects the United States at 5.3 percent and the rest of the world at about 3.5 percent, while Project LINK has the United States at 5.6 percent and the rest of the OECD at about 2.5 percent. This means that US demand for imports will be growing much faster than foreign demand for US exports.

1. For the methodology and detailed calculations, see John Williamson, The Exchange Rate System (Washington: Institute for International Economics, September 1983). His estimates are updated in "The Dollar Exchange Rate," a paper presented to a conference on "Europe and the Dollar" in Turin, Italy on June 4-5, 1984, especially pp. 8-10.

In addition, the US income elasticity of demand for imports is substantially higher than that abroad. US imports now tend to grow about 50 percent faster, compared with our GNP growth, as do imports abroad. So our trade balance will continue to deteriorate even if the United States grows a bit more slowly than the other industrial nations.

On the other hand, there should be a modest pickup in the imports of some debt-ridden developing countries, notably Mexico, which will help US exports. In addition, our terms of trade could continue to improve, as happened--due mainly to the strong dollar itself--throughout 1981-83 (masking much of the deterioration in our real trade balance). But the dominant net effect is dollar overvaluation, as has been the case since the trade deterioration began in 1981.

This trade outcome will in turn take the current account deficit to about $100 billion in 1984 and $125 billion in 1985. The surplus on services and unilateral transfers, which climbed as high as $33 billion in 1981, is declining sharply primarily because of our interest payments on the massive buildup of foreign investments here which are financing the current account deficit. (Even at interest rates of "only" 10 percent, the servicing costs in 1985 of a net capital inflow of $100 billion in 1984 produce a decline of $10 billion in the services account.) This surplus fell to about $20 billion in 1983. It could dip even lower in 1984, even taking into account some increase in our direct investment earnings because of a pickup in economies abroad.

It is particularly tricky to try to convert these trade numbers into their GNP equivalents, but an outcome as described could take 1 1/2-2 percentage points off economic growth in 1984. In the first quarter, domestic demand grew at an annual rate of about 11 percent although GNP--because of the increased trade deficit--rose by "only" 8.8 percent. The trade deterioration of about $100 billion from 1981 to 1984 means that by the end of this year there will be about 2 1/2 million fewer jobs--about three-quarters of them in manufacturing[2]--in the export and import-competing industries.

Contrary to the assertions of some Administration officials, and the views of some forecasters, the trade deterioration is virtually certain to continue at least into 1985. The pace of the deterioration, however, barring a further sharp rise in the dollar this year, is unlikely to be as great as in 1981-84.

The same factors as in 1984 suggest this outcome. The trade impact of the late-1983 rise in the dollar will continue into 1985, in view of the time lags involved, unless quickly reversed. Moreover, the "growth gap" is unlikely to be reversed--DRI sees US growth at about 3 1/2 percent compared with 3 percent or less for the rest of the world, while Project LINK sees both the United States and the rest of the OECD slightly above 3 percent.

2. Data Resources, Inc., The DRI Report on US Manufacturing Industries (January 1984), p. 65.

Quantitative forecasts are obviously less certain as the forecast period recedes into the future, but the merchandise deficit could easily approach $150 billion in 1985. The current account deficit would then be at least $125 billion. Enough additional job loss would occur in the tradeable goods sector to take the cumulative total, from 1981, to beyond three million. Barring a sharp US recession, with the rest of the world still growing at least modestly, or the long-expected but still absent correction of the exchange rate, there is no basis in current policy and prospects to foresee any turnaround in the US trade position--let alone a return to tolerable levels thereof.

Deindustrialization?

Beyond the trade deficits themselves, dollar overvaluation poses a growing threat to future investment in US plant and equipment. A large segment of American industry, running as high as 60-75 percent on some estimates, must now compete actively with firms based abroad either in world markets or here at home. Yet many of these firms are increasingly aware that the huge price disadvantage caused by dollar overvaluation may persist well into the future, if no action is taken to deal with the underlying cause of the problem--the budget deficit, and attendant high interest rates.[3]

3. Indeed, Martin Feldstein has argued repeatedly that dollar overvaluation and trade deficits will last as long as the large budget deficits--which other Administration officials have projected as lasting "as far ahead as the eye can see." Whether they are correct or not, widespread belief in these views will promote foreign rather than domestic investment by US firms.

Some firms are therefore beginning to question the wisdom of future investment in the United States. Continued sizable dollar overvaluation would be likely to force them to invest abroad instead, not from any "runaway plant" mentality but simply for self-preservation, particularly because their foreign competitors are enjoying such huge profits and may be reaping irreversible competitive gains. Indeed, massive foreign direct investment was one result of the last prolonged period of dollar overvaluation in the late 1960s and early 1970s.[4] Such a shift would of course further reduce job opportunitites in the United States. In addition to jeopardizing the sustainability of the present recovery, this phenomenon is probably the greatest present cause for concern over any future "deindustrialization" of our economy.[5]

4. There were of course other major reasons for the expansion of foreign direct investment by US-based firms during that period. However, the buildup correlates almost precisely with the growing dollar overvaluation and, given the inherent lags in corporate planning, so did its slowdown from the mid-1970s (after the dollar devaluations of 1971-73). Likewise, investment in the United States by foreign-based firms was small prior to those currency corrections but has expanded rapidly since then.

5. There is no inconsistency between this phenomenon and the continuing flow of direct investment by foreign-based multinationals into the United States. The latter is motivated primarily by the need to produce here to better serve the US market, which many believe will grow more rapidly than most other markets for some time to come, and to get behind the rising walls of protectionism triggered in large part by dollar overvaluation (see next section). In essence, both US and foreign multinationals are diversifying their portfolios to spread their production more evenly between US and foreign markets.

Protectionism

The history of US trade policy throughout the postwar period reveals that dollar overvaluation, even more than aggregate unemployment, is the most reliable "leading indicator" of protectionist trade pressure in this country.[6] The reason is clear: dollar overvaluation badly jeopardizes the competitive position of even our healthy import-competing industries, as well as those which are traditionally vulnerable. Hence the coalition which seeks import relief is broadened substantially.

The latest evidence for this relationship is the adoption by the current Administration, despite its philosophical devotion to open markets and free trade, of major protectionist steps in at least a half dozen industries (autos, textiles/apparel, steel, sugar, motorcycles, specialty steel). Indeed, important new trade controls were adopted in 1983 despite the substantial decline in the aggregate rate of unemployment and the pledge at the Williamsburg summit to roll back import controls "as recovery proceeds."

These pressures could become particularly intense in 1984 and 1985. As noted, the trade deficit will soar to $125-150 billion. Unemployment, though down sharply, will still be high--a great deal of it directly traceable to trade--and could begin rising again within the next 12-18 months. The election

6. C. Fred Bergsten and John Williamson, "Exchange Rates and Trade Policy," in William R. Cline, editor, Trade Policy in the 1980s, Washington: Institute for International Economics, November 1983.

campaign will generate intense pressures to support additional import relief.

Continued dollar overvaluation does undermine the traditional case for open trade, in part because the benefits of such trade would be skewed heavily against the United States. Indeed, Section 122 of the Trade Acc of 1974 authorizes use of an import surcharge "to deal with large and serious United States balance of payments deficits."[7]

Under flexible exchange rates, however, an import surcharge or other new import controls could well be ineffective or even counterproductive in seeking to reduce the trade deficit. As soon as such a step was implemented, the markets would expect a consequent improvement in the US trade balance. As a result, the exchange rate of the dollar could be expected to strengthen. (Evidence for this effect is provided by the episodic weakening of the yen over the past few years on news concerning possible new controls, in Europe as well as the United States, against Japanese exports.) Indeed, theory would suggest that the further overvaluation of our currency would fully offset the impact of the additional tariff.[8] Without necessarily trying to be so

7. It is not clear that this legal provision is being met, however, because on most definitions the United States is not running a "balance of payments" deficit: the net capital inflow is offsetting the deficit on current account. Moreover, Section 122 clearly did not contemplate the adoption of import controls to correct an excessively strong exchange rate for the dollar.

8. B. J. Eichengreen, "A Dynamic Model of Tariffs, Output and Employment Under Flexible Exchange Rates," Journal of International Economics, August 1981. In fact, Eichengreen concludes that increasing tariffs under flexible exchange rates, while it might create a modest number of jobs in the short run, would over time be likely to have a negative net impact on the level of employment.

precise, it seems likely that our overall trade balance would gain little if any from new import controls offset by induced dollar appreciation--as exporters were hurt substantially and import-competing firms and workers were helped much less net than gross.

Moreover, any adoption of such a major protectionist device by the United States at this time could topple the open trading system which has been so crucial to postwar prosperity. Europe, with its much higher level of unemployment and structural economic woes, would almost certainly reply in kind (or worse). The developing countries, seeing the evaporation of their only hope to earn their way out of the debt crisis, would tighten their own trade controls further (and might even be pushed over the brink to massive moratoria and/or defaults). The damage to the world economy, from adoption of a major restrictive step by the only industrial country which is enjoying substantial recovery and declining unemployment, would be all too reminiscent of the 1930s and could take years (or decades) to repair.

A "Stabilization Crisis"?

One other possibility, recently outlined by my colleague Stephen Marris, is that the trade deficit itself, along with a failure to deal with the budget deficits and fears of renewed inflation, will produce such a precipitate fall in the exchange rate of the dollar as to have major adverse consequences for our economy.[9] Such a fall would come from a sharp reversal in

9. Stephen Marris, "Crisis Ahead for the Dollar," Fortune, December 26, 1983.

capital flows, stemming from a collapse of international confidence in the sustainability of the American situation, which would then push US interest rates up both directly and--because the Federal Reserve might have to tighten money to stem the run on the dollar--indirectly.

Moreover, a sharp decline in the dollar would add significantly to inflationary pressures in the economy: a fall of 25 percent in the exchange rate would add three to four percentage points to the price level.[10] As a result, the United States would for a while get the worst of all worlds from its external accounts: a continued huge trade deficit, because of previous dollar overvaluation, and higher interest rates and new inflationary pressures as well from a rapid fall of the currency. Again, urgent action is required--to begin the adjustment process soon enough, primarily through action on the budget deficit, to foster the needed currency correction in a relatively smooth manner without a "free fall" à la 1978 and the enhanced risk of overshooting to an excessively weak (and inflationary) dollar once again.

10. The correction in the exchange rate of the dollar which is needed, as noted above, would of course also produce such an effect--but in a more orderly way over a longer period of time. Indeed, the inevitable upward push in the CPI from dollar depreciation--which, it should be noted, does not affect the "core" or "underlying" inflation rate--is better taken now than later, given the continuing low level of recorded inflation, thus adding to the urgency of restoring dollar equilibrium.

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The United States as a Debtor Country

One extremely important component of this scenario is a huge net inflow of capital into the United States to finance the current account deficits. It is not widely recognized, however, that the magnitude of this flow seems certain to convert the United States in only three years into a debtor nation--for the first time since World War I, reversing the 65-year buildup of our position as an international creditor country.

The cumulative current account deficits for 1983-85, as projected here, exceed $250 billion. At the end of 1982, the net US creditor position was only $168 billion. Hence that position could be virtually wiped out by the end of this year, and seems certain to disappear during 1985.[11]

Two statistical caveats are worth noting. On the one hand, US assets abroad consist much more heavily of direct investment ($221 billion, end-1982) than do foreign assets here ($102 billion). Since direct investment is calculated at book rather than market value, and since the stock of US direct investment abroad is considerably older on average than the stock of foreign direct investment here, our net creditor position on that account is probably understated.

11. The latest annual report of the Council of Economic Advisers, p. 57, agrees that the United States will probably move into net debtor status "sometime in 1985." Paul Volcker agrees, noting that the United States "would soon become the largest" debtor country in the world on current trends; see, for example, his statement of February 7, 1984 to the House Committee on Banking, Finance and Urban Affairs, pp. 12-13.

On the other hand, the extent of foreign capital flow to the United States in recent years has almost certainly been significantly understated. During 1978-82, the US accounts included an unrecorded inflow ("statistical discrepancy" or "errors and omissions") which cumulated to over $130 billion. Some of this could be unrecorded exports of services, but "the discrepancy was probably in large part accounted for by unrecorded capital inflows."[12] Hence, if anything, the official data today probably overstate rather than understate the US international creditor position--reducing the base from which its reversal is now underway.[13]

Thus the United States seems destined, in the course of only three years, to offset the buildup of net assets abroad which began during World War I. We would thereby return to our 19th-century status as a debtor nation, when we were a developing country.[14] Indeed, the magnitudes indicated by this analysis

12. Survey of Current Business, August 1983, p. 43, in explaining the anomalous further rise in the US international creditor position in 1982 despite a current account deficit of $11 billion. No such anomaly is conceivable in 1983-85, however, because of the much larger magnitude of the current account deficit. Moreover, the "statistical discrepancy" seems to have disappeared after the first quarter of 1983.

13. A third caveat is that valuation adjustments, such as the sharp rise in value of US stocks and bonds during 1982-83, also affect the international balance sheet of the United States in ways not related directly to the current account position.

14. The United States was still a net debtor, to the tune of $3.7 billion, in 1914 but had moved to creditor status of a similar magnitude by 1919. See Hal B. Lary, The United States in the World Economy, Department of Commerce, 1943, pp. 122-24.

suggest that the United States could be challenging Brazil and Mexico for ranking as the top debtor nation in the world by 1986.[15]

There are numerous implications which stem from this prospective shift of the richest country in the world to debtor status. One is the huge misallocation of world resources which is suggested. Another is increased vulnerability for the dollar; my earlier studies show that the dollar crises of the 1960s and early 1970s were all associated with a decline of key US "liquidity ratios"--the relationship between our reserve assets and foreign dollar holdings, on various definitions[16]--below 100 percent, and a shift to net debtor status could be expected to have at least as much impact.

One very practical effect of this shift is that the US current account will no longer benefit from net earnings on foreign investment--because the foreign investment account will be in deficit rather than surplus. Our net investment income peaked at over $33 billion in 1981, but already dropped by $6

15. Net external debt of both Brazil and Mexico will probably approximate $100 billion in 1986, as would that of the United States with the level of current account deficits suggested here. However, the debt-to-export ratio of the United States, at about 40 percent, would be more like that of Hungary, Romania and Thailand than Brazil and Mexico (over 200 percent even after substantial improvement by 1986). For the LDC numbers see William R. Cline, International Debt and the Stability of the World Economy (Washington: Institute for International Economics, September 1983), pp. 54-55, 132.

16. C. Fred Bergsten, The Dilemmas of the Dollar: The Economics and Politics of US International Monetary Policy (New York: New York University Press, for the Council on Foreign Relations, 1975), esp. pp. 148-152.

billion in 1982 and another $7 billion in 1983. As we service the huge buildup of foreign holdings here, the remaining surplus will decline precipitately and perhaps disappear by 1986--even taking account of the higher return on US assets abroad because of direct investment's greater share in them.

This in turn means that the United States will no longer be able to offset, via a services surplus, a merchandise trade deficit of $25-30 billion as was the case until 1981. Hence the required improvement in the trade balance, from the massive level of deficit to which it is now soaring, is even greater than would have been the case in the early 1980s to achieve equilibrium in the overall current account.

Is Dollar Overvaluation the Main Villain?

Before turning to proposed remedies, it is necessary to counter several critiques of this analysis which suggest that dollar overvaluation is not the primary cause of the massive US trade deterioration--or that the deterioration itself is not so serious.[17] I will address each of these critiques in turn.

First, it is argued that the recent domestic boom in the US economy--rather than dollar overvaluation--is the primary cause of the trade deficit. As noted above, it is certainly true that the faster recovery here than abroad has contributed to the deterioration.

17. As in Robert Solomon, "The US Trade Deficit," International Economic Letter, May 16, 1984; Morgan Guaranty, World Financial Markets, July 1983 and October 1983; and Mieczyslaw Karczmar, "A Strong Currency Has Its Good Side," New York Times, August 14, 1983, p. F3.

However, this argument overlooks the crucial fact that real net exports of goods and services--as calculated for, and included in, the GNP accounts--had already deteriorated enormously during our recession of 1981-82.[18] As noted, this deterioration in fact accounted for about three quarters of the total decline in the economy and was by far the largest cause of the recession--being twice as large as the housing slump, for example. In essence, an improvement in our terms of trade, due primarily to the sharp rise in the value of the dollar itself, masked the huge competitive losses we were already suffering from dollar overvaluation as early as 1981-82.

The focus on income effects also overlooks the well established relationship, cited above, between losses of US price competitiveness and trade deterioration. We lose $2-3 billion of trade balance for every loss of one percentage point in price relationships. Since the dollar rose by a trade-weighted average of 30-40 percent (depending on the index used) from mid-1980 to its current peaks, reached initially in mid-1981, most of the deterioration from 1980-81 to 1984 ($100 billion) or even 1985 ($125 billion, on my calculation) can be explained by the exchange rate changes.

It should also be noted that, although the US recovery in 1983-84 has been by far the sharpest among industrial countries, so was the US recession of 1981-82 the deepest. Hence our trade

18. Solomon also argues (p. 4) that the recent upturn in exports "contributed to the rise in American GNP." It is changes in the real trade balance which affect the GNP, of course; this balance has continued to deteriorate sharply, as noted in the text, and thus reduced our GNP steadily since early 1981.

balance should have experienced cyclical gains at that time--reinforced by the very sizable drop in oil imports--rather than the sizable real deterioration which took place. For the entire period of trade deterioration, 1981-84, the cyclical loss is much less than one would suspect from looking at just the past year.[19]

A second critique is that the trade deficit should decline in the future as a result of dollar depreciation and a slowdown in US growth relative to the other industrial countries. I, too, have expected a dollar decline for some time. However, as noted, the dollar is in fact continuing to hit new highs, and the outlook for further rises in US interest rates suggests that it may keep climbing for some time. Hence no relief can be assured from that quarter.

As to growth, it is noted above that the United States has a substantially higher income elasticity of demand for imports than the other industrial countries (as a group). Hence the United States would have to grow much more slowly than they to cut its trade deficit via income effects. The current prospect is for quite an opposite pattern, at least through 1985, so no relief can be assured there either.

Third, it is noted that an important part of Europe's recent economic recovery can be linked to its increased exports to the United States. The US deficits are, in fact, sometimes praised for providing a "global Keynesian stimulus" to the rest of the world.

19. The same point holds with regard to the recent adverse effect on US exports of the LDC debt crisis. To be sure, our trade balance suffered from reduced LDC (especially Mexican) imports in 1983-84. But it had gained enormously from their rapid growth through 1981-82; a slightly longer view reveals little net loss to US trade from changes in the LDC position.

However, this "partial equilibrium analysis" ignores the adverse impact on European growth of the same high US interest rates which have caused much of the dollar overvaluation and thus enabled Europe to sell more here.[20] As noted below, high US interest rates have forced European (and Japanese) interest rates to levels which are clearly higher than called for by their domestic needs. Hence domestic demand in those countries has been discouraged, perhaps by enough to offset the expansionary effect of the export growth induced by the high dollar.

Fourth, at least one major analyst (Morgan Guaranty) has suggested that the extent of dollar overvaluation is "only" 10-15 percent rather than the 25 percent which derives from our own (and most other) studies. It turns out, however, that this conclusion results from this analyst's replacing its own traditional (March 1973) base for purchasing power parity comparisons--which led to conclusions similar to my own--with a 1980-82 base. The problem, of course, is that this new base itself incorporates the massive dollar overvaluation which is the source of the problem--and thus, in essence, assumes away much of the problem.

The justification for doing so is that the US policy framework of 1980-82 is more likely than the framework of the 1970s to be typical for the future. One certainly hopes this is

20. Solomon rightly notes that I have also implied use of partial equilibrium analysis in stating that the rising trade deficit has "created 2-3 million lost jobs" in the United States. There are of course offsetting gains in non-trade sectors from the lower inflation and interest rates attendant to the trade deficits. As in this statement, I will henceforth state clearly that the job loss cited is limited to "export and import-competing industries."

true as regards inflation and the energy situation. However, most would certainly hope it is not true regarding the level of unemployment (which rose steadily and peaked in precisely this period), the budget deficits, the level of interest rates and the trade deficits themselves. In essence, the Morgan Guaranty argument suggests that the massive trade deficits now being experienced are with us to stay--which I would view as wholly unsustainable, as well as wholly undesirable.[21]

Fifth, and closely related, it is argued that at least some substantial part of the current US external imbalance is sustainable and even desirable--despite the implied permanent loss of jobs and production in the tradeable goods sectors. This is also tantamount, of course, to expecting continuing large inflows of capital to the United States indefinitely--reversing our traditional role as a capital exporter, steadily adding to our position as a debtor country, and requiring high (and, depending on the situation in other countries, probably rising) levels of US interest rates. It seems that there are strong economic, and even national security, reasons for rejecting such an image of America's future.

Finally, some have noted that an appreciating dollar holds down US inflation and brings desirable competitive pressures to bear on American firms and workers. To be sure, the recorded

21. During 1983, this argument also suggested that the level of the US current account deficit was being substantially overstated because the large positive "errors and ommissions" item concealed as much as $20-25 billion of unrecorded services exports. However, the positive errors and ommissions have disappeared since the second quarter of 1983--just when the deficit began soaring to its record peaks.

level of prices has been lower due to the strong dollar--perhaps by as much as 4-6 percentage points by now, implying annual inflation rates 2-3 percentage points lower.

Unfortunately, unless one believes that the huge trade deficits and capital inflows are sustainable, these anti-inflation gains are inherently temporary. The core, or underlying, rate of inflation remains at about 5-6 percent. Indeed, the inevitable dollar decline will both give up the gains from appreciation in reducing reported inflation below the core level (say, from 5-6 percent to about 3 percent, all other things equal) and, through renewed depreciation, push the reported numbers well above the core rate (say, from 5-6 percent to about 8 percent) until the correction is completed and the reported numbers, all other things equal, drop back to the underlying rate. So the anti-inflation effect, while welcome, is almost certainly temporary--and could even mislead us into thinking that underlying inflation has been brought under much more effective control than is the case.

What to Do

Even if one were to quarrel with the precise magnitude of all these estimates, it is hard to escape the overall conclusion: that the United States is now experiencing a massive, historically unprecedented erosion of its international trade and financial position. Moreover, given the time lags involved and policies now in place, it is too late to change the picture for 1984 and it is getting late to do much for 1985. The outlook is so dire--and the likelihood so uncertain of achieving the needed correction in a healthy manner, if at all, under

present policies--that the case for early action seems compelling.

Of course, the dollar could at some point begin to fall rapidly as a result of the US trade and current account deficits themselves, along with continued failure to resolve the budget problem. US capital outflows, which fell sharply in 1983, could accelerate again as economic recovery picks up abroad. A renewed outbreak of inflationary expectations here could--most unfortunately, in this instance--promote correction of the dollar, as could the (also unfortunate) adoption of new stabilization measures (including higher interest rates) by other key currency countries.

None of these developments can be accorded a high probability in the short run, however, and dollar correction via renewed inflation expectations would raise major problems of its own. Moreover, as emphasized throughout these remarks, the situation is getting steadily worse. Decisive action to reduce the budget deficits (and hence interest rates) thus remains the most critically needed step to resolve our external problems (as well as central internal problems). Failing such action, however, it may be necessary to adopt "second best" measures aimed directly at the proximate source of the problem: the capital flows which are swamping the trade and current account balances and prompting exchange-rate relationships which are so at variance with underlying competitive realities.

In this context, there was a recent opportunity to improve the situation. During February and early March, the DM (and other European currencies) moved up sharply against the dollar.

The yen joined the move in early March as well. As in two earlier cases when the yen moved up strongly (late 1982 and fall 1983), serious joint intervention by the United States and the countries whose currencies were rising--building on the market swing--could have intensified its speed and extent and perhaps assured that it would, at last, represent the permanent turning of the tide that is needed. The central banks would obviously have to be careful that they did not trigger an excessive ("bandwagon") move and be ready to change course if that seemed to be occurring, and I would not have counselled pro-cyclical intervention when the DM shot up for one day on May 24 in the wake of the "run" on US bank stocks, but the failure to act in the face of excessive dollar strength over the past three years has clearly been a mistake.

Since no action was taken, however, the currency reversal once again stalled out and reversed itself, representing merely another false start with no lasting impact. The need here is to reverse the existing thrust of intervention policy: to "lean with the wind" when it is blowing toward underlying equilibrium, rather than always "leaning against the wind" to smooth short-run market "disorder" (or abstaining from engagement altogether).

In considering how to manipulate capital flows on a more lasting basis, if that turns out to be necessary, it is important to recognize that many other nations are also being hurt by the nexus of high US interest rates and dollar overvaluation. To be sure, their trade balances gain as the United States suffers the massive trade deterioration described above. But this effect, for most countries, is probably more than offset by the

depressing effect of high US interest rates on domestic demand within their borders.

In fact, most other countries cannot now use monetary policy to promote economic recovery. For example, Germany raised its key interest rate in September 1983 despite the very modest growth of its economy. Japan, to avoid further weakening of the yen and intensified protectionist reactions, has for over two years kept its interest rates at least two percentage points higher than called for by domestic conditions. Most of these same countries are determined to tighten their budgetary policies, for long-run reasons of fiscal prudence and judgments concerning more immediate confidence and supply-side effects. The result is that most major countries--including Japan, Germany and the United Kingdom--have no policy tools available to promote more rapid rates of expansion.[22]

In addition, all countries suffer from the intensification of the global debt crisis caused by dollar overvaluation and high US interest rates. And the protectionist pressures in the United States which relate directly to dollar overvaluation, and threaten to block some of the export expansion which others could enjoy due to their currency undervaluations, are also a major source of concern abroad.

All countries thus have a major interest in launching steps to correct the situation. This interest has recently been manifest in calls by the French Minister of Economy, Finance and

22. Note the irony that the adverse effects of slow foreign growth on the US trade balance also relate, in part, to our own bizarre mix of loose fiscal policy and high interest rates.

Budget, the architect of his country's quite orthodox austerity program, and the Social Democratic Party in Germany, for Europe to seek ways to "decouple" from the dollar.

One way to do so would be for the European countries and Japan to begin borrowing heavily abroad to promote capital inflow and strengthen their currencies. Indeed, Japan agreed to do so--via floating so-called "Nakasone bonds"--when President Reagan visited Tokyo last November. However, only a miniscule amount of such bonds ($100 million) has been floated and the Treasury apparently ignored the issue while negotiating the recently announced "yen agreement."

The need is for Japan and the Europeans to announce major foreign borrowing programs, as the United States announced a willingness to borrow abroad up to $10 billion in November 1978 to help shore up the dollar--successfully, as it turned out. Their reluctance to pay high (dollar) interest rates should be offset by the prospect of sharp capital gains, as they repay in dollars purchased when their own currencies become much stronger, just as the United States Treasury profited by hundreds of millions of dollars on the "Carter bonds" of 1978.

In addition, Europe and Japan could crack down on their capital outflows.[23] For example, they could install an Interest

23. In principle, the United States could also try to limit capital inflow, as Germany and Switzerland did in the late 1960s and early 1970s. However, the vast size of the US capital market and the widespread international use of the dollar, along with the fact that it is always easier to control your own residents than non-residents, suggests greater effectiveness of actions initiated by the other countries (but, as noted below, fully supported by the United States).

Equalization Tax (IET), as the United States did in 1963 when faced by similar circumstances: a current account surplus more than offset by capital outflow due largely to higher interest rates abroad. The US IET only worked for a couple of years, although it stayed on the books until 1974, but it exempted much of the capital account and a good part of the world so is not a very precise model for similar action today.

A contemporary effort by Europe and Japan would have to be quite comprehensive in scope, except perhaps for bona fide export finance and credits to debtor developing countries, and applied much more vigorously. Given the magnitude of today's capital markets, there would be considerable leakage. But many billions of dollars of capital outflow could presumably be checked rather quickly, turning the tide in the exchange markets.

Those who recall the relatively modest (and short-lived) results of the US capital restraints of the 1960s also ignore one vital difference between then and now. If Europe and Japan took such action today, they would be moving <u>toward</u> underlying equilibrium whereas the United States was trying to shore up a currency which turned out to be substantially overvalued. Thus a European-Japanese IET would be moving <u>with</u>, not against, underlying market forces and should have a good chance of working. The key is to achieve a convincing shift in short-run market trends, which could be done by offsetting the interest-rate advantage that temporarily props the dollar, without permanently distorting the international capital markets.

Alternatively, the Europeans and Japanese could simply shut down most capital exports for a while through quantitative

controls. Japan, in particular, could use administrative guidance to check temporarily the massive foreign investments of its insurance companies, banks and other large institutional investors.[24] The techniques involved should be determined by each country, but implemented jointly and quickly to have the desired psychological as well as real effect on the exchange markets.

Once the tides were turned, and the correction was underway, joint intervention in the exchange markets by the US and foreign authorities could accelerate its pace and extent. In addition to joining the intervention effort once the market trends were turned, the United States would of course have to endorse fully the actions of the capital-exporting countries (to obviate any fears that their actions were taken "against the United States").

To be sure, steps aimed at direct manipulation of capital flows (or exchange rates themselves) are decidedly inferior to dealing with the fundamentals of the situation: primarily the huge ongoing budget deficits in the United States and the resulting high real interest rates which support the dollar at

24. As they are already doing to some extent, e.g., by limiting the foreign investments of Japanese insurance companies to 20 percent of their new premium income. It should be noted, however, that the thrust of the recent US-Japan financial agreement was for Japan to open its capital markets further -- which could well promote more capital outflow and thus again weaken the yen. At best, the new steps announced this week will strengthen the yen only over an extended period of time--and are more likely simply to increase the amplitude of its fluctuations. For recommendations on the yen see C. Fred Bergsten, "What to Do About the US-Japan Economic Conflict," Foreign Affairs, Summer 1982.

overvalued levels. Action on these basics must, and surely will, eventually occur.[25] But the uncertain outlook for their early resolution and the costs of inaction--as detailed above--are extremely high and growing steadily worse. It is thus critically important that this committee, and the rest of the Congress, move decisively as soon as possible to enact substantial, lasting, and credible reductions in the budget deficits--for external as well as internal reasons.

25. Detailed proposals for doing so are offered in the latest statement of the Bipartisan Budget Appeal, organized by former Secretary of Commerce Peter G. Peterson and five former Secretaries of the Treasury, as published in the New York Times and Wall Street Journal on May 4, 1984.

Senator HEINZ. Mr. Heller.

STATEMENT OF H. ROBERT HELLER, VICE PRESIDENT FOR INTERNATIONAL ECONOMICS BANK OF AMERICA

Mr. HELLER. Thank you very much, Mr. Chairman.

The international competitiveness of American products is determined in a fundamental way by the value of the U.S. dollar.

The sustained strength of the U.S. dollar has surprised many observers during recent years.

STARK CONTRAST TO CONDITIONS 4 OR 5 YEARS AGO

The current situation is in stark contrast to the conditions 4 to 5 years ago. At that time, a weak U.S. dollar was a matter of great concern to Americans and to the administration. Emergency stabilization measures were initiated by the Federal Reserve and the U.S. Treasury, and the U.S. Government also mobilized some of the financial resources available from the International Monetary Fund and activated our swap-lines with foreign central banks.

Are we, as a nation, better off now or then? Do American producers and consumers benefit from a high dollar or from a low dollar? And if the dollar is overvalued now, should we attempt to bring about a reduction in its exchange value? Indeed, should we try to trade places with the countries that are currently presumably enjoying the benefits of undervalued currencies?

These are important questions that the Congress and the administration have to confront.

In my remarks I will focus first of all on the cause of the current strength in the exchange value of the dollar.

Second, I will stress the impact of the dollar strength on the competitiveness of American producers. And third, I will attempt to draw some brief conclusions regarding policy implications of these findings.

As has been testified before, the average exchange value of the dollar is now higher than it has ever been. Does this increase in the value of the dollar imply that is actually overvalued? Because the U.S. dollar is a freely traded currency in the international markets and because the Government does not artificially peg the value of the dollar, one may well conclude that the dollar is neither overvalued nor undervalued, according to this free market standard. Nevertheless, many observers argue that the dollar is overvalued on purchasing power parity grounds. This standard is clearly based on the notion that only trade in goods and services should determine the value of a currency and that the goods and services account should, therefore, be balanced.

It is questionable that such a standard would make much sense. The simple arithmetic of double entry bookkeeping assures that any deficit in the current account has to be counterbalanced by a surplus in the capital account, and if the current account deficit is taken as evidence for an overvaluation of the dollar, we should take the capital account surplus as evidence for an undervaluation of the dollar.

We may conclude that the statement that a currency is overvalued or undervalued does not make much sense for freely traded

currencies such as the dollar where Government intervention is negligible.

This brings us back to the question why the dollar is so strong at the present time. One factor which certainly can be discounted immediately as a possible source of dollar strength is the American trade performance. We are now spending $120 billion more per year than we are earning. And this excess supply of dollars has a depressing effect on the value of the dollar. However, trade-related transactions represent now less than 10 percent of the sum total of foreign exchange transactions that take place. I believe these numbers are roughly in congruence with the numbers that Secretary McNamar was mentioning earlier. It is, therefore, not surprising that the value of the dollar can deviate rather substantially from its purchasing power parity, based on trade transactions alone. Capital account transactions keep the dollar strong by creating a net demand for dollars in foreign exchange markets.

Total foreign capital inflows into the United States have been rather stable at slightly more than $80 billion per year since 1981. But the big change has come in U.S. capital outflows, which have been cut drastically from $118 billion in 1982 to only $49 billion in 1983. Foreign capital inflows are not increasing, but Americans are keeping more money at home.

REASONS FOR REDUCTION IN CAPITAL OUTFLOW

The reasons for this development are manifold. First of all, the United States is at the present time the most vigorous major economy in the world, and it's natural that Americans invest their resources at home and that foreigners also place funds here in an attempt to benefit from our economic boom.

Second, the U.S. inflation rate has been reduced sharply, making the dollar again a valuable and stable asset.

Third, the deregulation of large sectors of the American economy has provided new investment opportunities here.

Fourth, international lending by U.S. banks has been curtailed sharply due to the increasing regulation of international banking, new capital adequacy requirements, the sluggish growth performance of other countries and the debt service difficulties encountered by many developing nations.

And fifth, the great political and social stability enjoyed by the United States contrasts with political unrest and social problems in almost every other continent.

All these factors have combined to reduce foreign lending by U.S. banks from $109 billion in 1982 to $25 billion in 1983. This $84 billion swing in U.S. bank lending was the dominant factor responsible for the reduction in U.S. capital outflows. And given the foreign capital inflows of $83 billion total, the United States was a net importer of $30 billion of capital in 1983. These net capital inflows represent a net demand for dollar assets, and they caused the strong performance of the dollar in U.S. foreign exchange markets.

What are the implications of that dollar strength for the competitiveness of U.S. exports? Other things equal, a strong dollar will make it more difficult for American exports to compete in the international marketplace. Few people would deny the truth of

that statement. Nevertheless, when all the economic interactions are taken into account, we may come to the conclusion that Americans benefit from the strong dollar, even as far as the overall competitiveness of U.S. industry in world markets and job creation in the United States is concerned.

While there has been a noticeable parallelism between the value of the dollar in foreign exchange markets and the trade balance, the weak economic performance of many foreign economies is perhaps even more important in explaining the trading results achieved by U.S. exporters. While imports into the United States were more or less stagnant in the early 1980's, export fell from their peak of $234 billion in 1981 to $201 billion in 1983. These export declines were concentrated in Latin America, where our exports dropped some 40 percent.

An important indicator of the competitiveness of a country's industry is the world market share that is obtained by that country's exports. The world market share held by the United States has remained more or less constant at 12 percent during periods of dollar weakness and at dollar strength.

If other countries' exports to the United States are excluded, the picture is even more positive. The U.S. market share in Third World countries was approximately 17 percent in the years of dollar weakness, 1979–80. And as the dollar has strengthened, the market share of U.S. exporters improved to about 20 percent and has held more or less steady since.

This rather favorable performance in an adverse environment was made possible by the availability of additional capital that benefited the U.S. economy. Since the end of 1979, the total amount of foreign direct investment in this country has more than doubled from $54 billion to $111 billion by the end of 1983. These investments, in conjunction with the American capital that stayed home, helped to fuel recovery and finance the rejuvenation of American industry. The additional capital also helped to make American workers more productive and therefore, helped to sustain our international competitiveness, even in an environment of dollar appreciation. The potential job losses in export industries due to the strength of the dollar have to be balanced against the job-creating effects of the net capital inflows into the United States.

U.S. JOB MARKET BETTER THAN EUROPEAN COUNTERPARTS

I think Secretary McNamar's chart showed very well that on balance, the United States gained 6 million jobs since 1980, while our European trading partners, who presumably were benefiting from an undervaluation of their currencies actually lost jobs.

Whether it is more advantageous for the United States to run a surplus on current account and to export capital or it's better to run a current account deficit and to import capital is to an important extent determined by the productivity of that capital in this country and abroad. The high real-interest rates prevailing in this country are an indicator that capital today is relatively more scarce in the United States than abroad. It also indicates that the productivity of capital in this country is higher than it is abroad.

The strong U.S. recovery and the much slower growth observed abroad are certainly supportive of that particular point.

Let me conclude, Mr. Chairman, that overall, the strong dollar, has benefited rather than harmed the United States. Our current export problems stem much more from the stagnant economic conditions abroad rather than the strength of the dollar. The proper remedy is the rejuvenation of foreign economic growth rather than the imposition of trade barriers that artificially depress U.S. imports below their natural level. Protectionism would clearly be to the detriment of American consumers and of many U.S. producers as well.

The net capital inflows into the United States have helped to stimulate our recovery, increased our competitiveness and created jobs for Americans. And I believe they represent a strong vote of confidence in the U.S. economy.

Thank you, Mr. Chairman.

Senator HEINZ. Mr. Heller, thank you.

[The complete statement follows:]

Statement by

H. Robert Heller
Bank of America NT&SA
San Francisco, California

The Competitiveness of the Dollar

The international competitiveness of American products is determined in a fundamental way by the exchange value of the dollar. The dollar exchange rate directly affects the final price received by American exporters abroad and the price obtained by foreign sellers in the United States. The value of the dollar is therefore a parameter that is of great significance and interest to American producers and consumers alike.

The sustained strength of the dollar in foreign exchange markets since 1980 has surprised many observers. It has also raised questions regarding the causes and consequences of this phenomenon. Is the dollar overvalued? If yes, what are the key factors responsible for this overvaluation? What are the consequences of this for the competitiveness of U.S. industry and American workers? What is the impact of the exchange rate on our overall economic performance? Are any policy actions called for?

The current situation stands in stark contrast to the conditions four to five years ago. At that time, the weak dollar was a matter of grave concern to Americans and the Administration. Emergency stabilization measures were initiated by the Federal Reserve and the Treasury. The United States government also mobilized some of the financial resources available from the International Monetary Fund and activated our swap-lines with foreign central banks.

Are we as a nation better off now or then? Do American producers and consumers benefit from a high dollar or from a low dollar? If the dollar is overvalued now, should we attempt to bring about a reduction in its exchange value? Would we benefit from a return to the exchange values of the late 1970's? These are important policy questions that the Congress and the Administration have to confront.

In my remarks I will focus first on the causes of the current strength in the exchange value of the dollar. Second, I will address the impact of the dollar strength on the competitiveness of American producers. Third, I will attempt to draw some conclusions regarding the policy implications of our findings.

1. The Causes of Dollar Strength

The average exchange value of the dollar is now higher than it has ever been. Compared to the currencies of 14 industrialized countries, the dollar is now worth 25 percent more than it was in 1980. If one compares the value of the dollar to a broader sample of 67 currencies, the rise in the value of the dollar is even more dramatic: according to this measure, the value of the dollar has increased by over 50 percent since 1980.

Does this increase in the value of the dollar imply that the dollar is now overvalued? The appropriate value of a currency

cannot be inferred by comparisons to arbitrarily selected base periods. Instead, the value of a currency -- just like that of any other asset -- is established in the market place. Because the dollar is freely traded in international currency markets and the government does not artificially peg the value of the dollar, we must conclude that the dollar is neither overvalued or undervalued according to this free market standard.

This is in contrast to a currency whose value is directly influenced or managed by the government. Such a managed currency might be overvalued or undervalued if its value is pushed to a level that deviates from the one that would prevail in free markets.

Nevertheless, many observers would argue that the dollar is overvalued on grounds of purchasing power parity. This standard is based on the notion that only trade in goods and services should determine the value of a currency and that the goods and services account should always be balanced. It is questionable that such a standard would make much sense.

The simple arithmetic of double-entry bookkeeping assures that any deficit in the current account of the balance of payments has to be counterbalanced by a surplus on capital account. If the current account deficit is taken as evidence for an overvaluation of the currency, the capital account surplus should be evidence of an undervaluation of the currency. Thus it is very difficult

to single out any account in the balance of payments according to which the overvaluation or undervaluation of a currency might be established.

We may conclude that the statement that a currency is overvalued or undervalued does not make much sense for a freely traded currency, such as the dollar, where governmental intervention is negligible. The concept of overvaluation or undervaluation is relevant only for currencies whose value is artificially influenced by governmental restrictions or intervention policies.

This brings us back to the question why the dollar is so strong at the present time. One factor which can be discounted immediately as a possible source of strength for the U.S. dollar is the American trade performance. Never before has the United States experienced such large trade and current account deficits--both as far as the absolute dollar value and the relative size compared to the national product is concerned. During the first quarter of this year, the trade deficit ran at an annual rate of $119 billion, and the current account deficit amounted to $70 billion. The demand for dollars on behalf of foreigners who wish to purchase U.S. exports is therefore much smaller than the supply of dollars offered in foreign exchange markets by Americans who wish to purchase foreign goods. This excess supply of dollars has a depressing effect on the value of the dollar.

However, trade-related transactions represent only a relatively small fraction of the sum total of the foreign exchange transactions that influence the value of the dollar in foreign exchange markets. U.S. trade in goods and services (exports plus imports) amounts now to about $700 billion per annum. According to the April 1983 Federal Reserve survey of activity in the U.S. foreign exchange market, the annual foreign exchange transaction volume within the United States itself is approximately $7,000 billion per year. This survey does not cover the very substantial dollar trading activity taking place in foreign countries. That is, foreign trade transactions account much less than 10 percent of all foreign currency transactions. It is therefore not surprising that the value of the dollar can deviate rather substantially from its purchasing power parity based on trade transactions alone.

The rapid growth of international financial markets in the last decades has led to a situation where the value of the dollar in foreign exchange markets is predominantly determined by international financial flows rather than foreign trade transactions. The capital account transactions keep the dollar strong by creating a net demand for dollars in foreign exchange markets. It is therefore appropriate to analyze the factors responsible for the net inflow of capital into the United States.

Foreign capital inflows into the United States have been rather stable at slightly more than $80 billion per year since 1981. The

big change has come in U.S. capital outflows, which have been cut from $118 billion in 1982 to only $49 billion in 1983. Foreign capital inflows are not increasing, but Americans are investing more funds at home.

The reasons for this development are manifold: first of all, the U.S. is at the present time the most vigorous major economy in the world. It is therefore natural that Americans invest their resources at home and that foreigners also place funds here in an attempt to benefit from our economic boom.

Second, the U.S. inflation rate has been reduced sharply, making the dollar again a valuable and stable asset.

Third, the deregulation of large sectors of the American economy has provided new investment opportunities. Consequently, American capital is staying at home.

Fourth, international lending by U.S. banks has been curtailed sharply due to the increasing regulation of international banking activities, new capital adequacy requirements, the sluggish growth performance of other countries,and the debt service difficulties encountered by many developing countries.

Fifth, the great political and social stability enjoyed by the United States contrasts with political unrest in Latin America, uncertainty about Hong Kong's future, the war in the Middle East,

and growing labor problems in many European countries. The political and social instability abroad increases the incentive to move funds to the United States and lessens the desirability for Americans to invest abroad.

All these factors have combined to reduce foreign lending by U.S. banks from $109 billion in 1982 to $25 billion in 1983. This $84 billion swing in U.S. international bank lending was the dominant factor responsible for the reduction in U.S. capital outflows from $118 in 1982 to $49 billion in 1983. Given the foreign capital inflow of $83 billion dollars, the United States was a net importer of $34 billion of capital in 1983.

These net capital inflows represent a net demand for dollar assets on behalf of foreigners and Americans alike and cause the strong performance of the dollar in foreign exchange markets. What are the implications of this dollar strength for the competitiveness of U.S. exporters? This is the question which we will turn to next.

2. The Impact of the Strong Dollar on U.S. Competitiveness

Other things equal, a strong dollar will make it more difficult for American exporters to compete in the international market place. Few people would deny the truth of this statement. Nevertheless, this narrow Keynesian and mercantilistic perspective leaves out important considerations that, when fully

taken into account, may well lead to the conclusion that Americans nevertheless benefit from the strong dollar -- even as far as the overall competitiveness of U.S. industry in world markets and job creation in the U.S. is concerned.

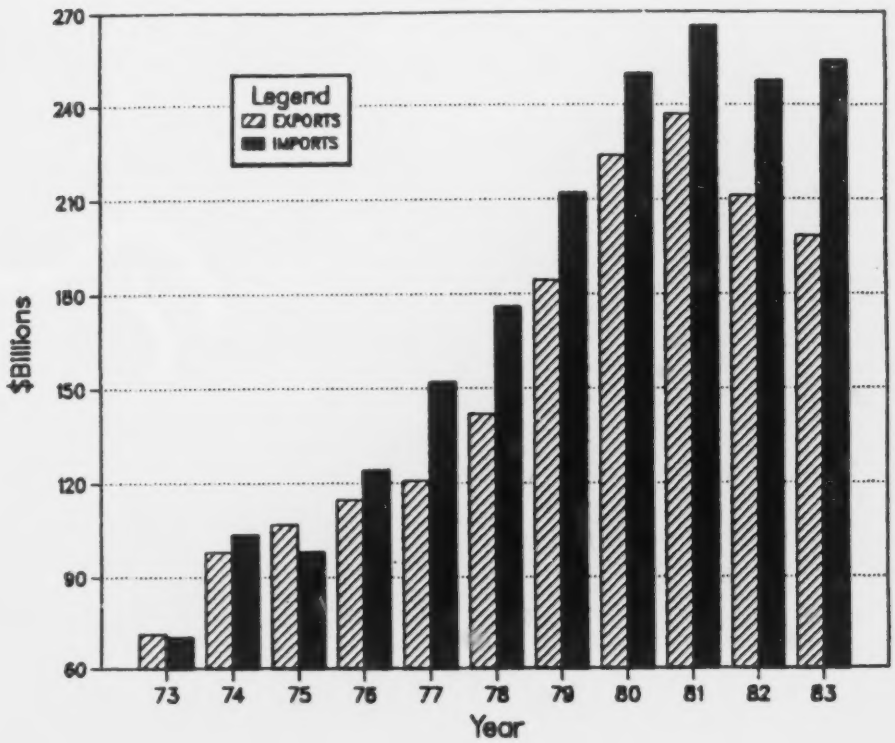
During the last few years, there has been a noticeable parallelism between the value of the dollar in foreign exchange markets and the trade balance. In 1978-80, when the value of the dollar was rather low, the merchandise trade deficit amounted to $25 to $30 billion dollars per year. Since then, the dollar has appreciated and the merchandise trade deficit has widenend to over $100 billion in the first quarter of 1984.

But the weak economic performance of many foreign economies is perhaps even more important in explaining the trading results achieved by U.S. exporters. Figure 1 shows that while imports into the United States were more or less stagnant in the early eighties, exports fell from their peak of $234 billion in 1981 to $201 billion in 1983. The export declines were concentrated in Latin America, where debt service problems and governmental austerity programs drastically curtailed import spending. United States exports to Latin America dropped some 40 percent between 1981 and 1983, and U.S. exports to the industrialized countries have stagnated since 1980.

The depressed economic conditions abroad are therefore a key factor explaining the U.S. trade performance. If only exchange

Figure 1

U.S. MERCHANDISE EXPORTS & IMPORTS



Note: 1983 first three quarters at annual rates.

rates were to be held responsible for the deterioration of the U.S. trade balance, one might have expected to see a strong surge in imports and a slowdown in exports -- but not import stagnation and an export collapse. We may conclude that the depressed level of U.S. exports, rather than a surge in U.S. imports, are central to the disappointing U.S. trade performance.

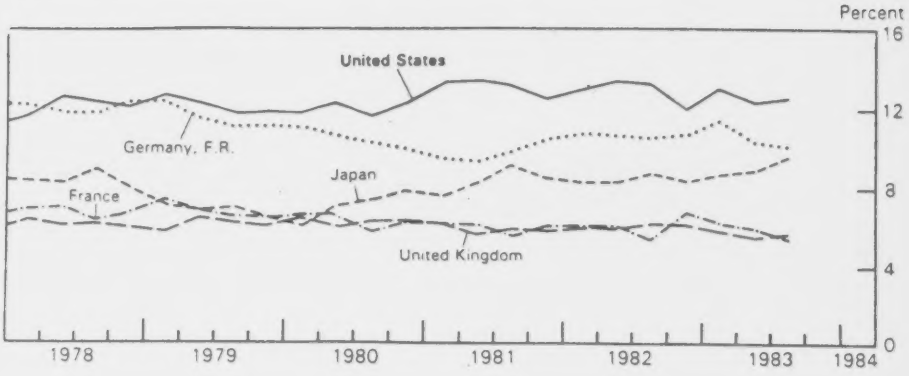
An important indicator of the competitiveness of a country's industry is the world market share that is attained by that country's exports. Figure 2 shows that the world export market share held by the United States has remained more or less constant at 12 percent during periods of dollar weakness and dollar strength. If other countries' exports to the United States are excluded, the picture is even more positive as shown in Figure 3. The U.S. market share in third countries was approximately 17 percent in the years of dollar weakness (1978-79). As the dollar strengthened, the market share of U.S. exporters improved to about 20 percent and has held more or less steady since then.

Figures 2 and 3 also show that the Japanese have gained export market share mainly at the expense of Germany and the United Kingdom.

How can the good competitive performance of the United States be explained in the face of a rising trade deficit? First of all, it should be emphasized again that the U.S. trade deficit is not due to a surge in U.S. imports, but a collapse of U.S. exports due to

Figure 2

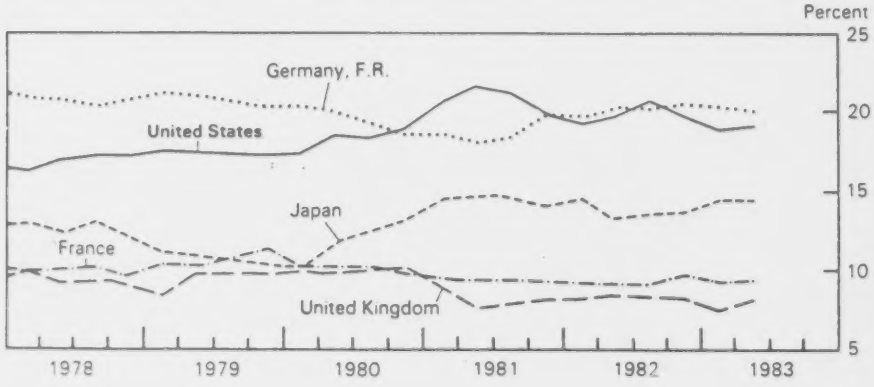
Market Shares of Free-World Exports



Source: Department of Commerce

Figure 3

Market Shares of World Exports of Manufactures
(Excluding exports to the United States.)



Source: Department of Commerce

depressed economic conditions abroad. Second, the U.S. has been able to maintain its market share in a stagnant world market.

This rather favorable performance in an adverse environment was made possible by availability of additional capital that benefited the U.S. economy. Since the end of 1979, the total amount of foreign direct investment in this country has more than doubled from $54 billion to $111 billion by the end of 1983. These investments, in conjunction with the American capital that "stayed home" helped to fuel the recovery and finance the rejuvenation of American industry. The additional capital also helped to make American workers more productive, and therefore helped them to sustain their international competitiveness even in an environment of dollar appreciation. The potential job losses in export industries due to the strength of the dollar have to be balanced against the job creating effects of the net capital inflows into the United States.

Whether it is more advantageous for the United States to run a surplus on current account and to export capital or whether it is better to run a current account deficit and to import capital is determined to an important extent by the productivity of capital in this country and abroad. The high real interest rates prevailing in this country are an indicator that capital is today relatively more scarce in the United States than abroad. It also indicates that the productivity of capital in this country is higher than it is abroad. The strong U.S. recovery and the much

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slower economic growth observed abroad certainly support this point.

Finally, the argument made by students of economic development, namely that a rapidly developing country can be expected to run a current account deficit and to be a net importer of capital is an important point to bear in mind. At the present time, the United States simply is one of the most rapidly growing economies in the world, and its balance of payments constellation is characteristic of a rapidly developing country.

Without belaboring the point, it is worth pointing out that most of the now stagnant economies of Latin America run sizeable trade surpluses, and that some of these countries even run current account surpluses. At the same time, these economies are experiencing a severe economic downturn and unemployment is rampant. A trade surplus is certainly no guarantee for full employment.

3. Conclusions and Policy Implications

What conclusions and policy implications emerge from this analysis?

One, while the strengthening of the dollar since 1980 has been accompanied by a deterioration of the U.S. trade and current account balance, the capital inflows into the United States have

helped to increase growth, enhance productivity, and create new jobs in the United States. Measures that reduce the current account deficit will -- pari passu -- reduce capital inflows and thereby diminish an important factor sustaining the U.S. recovery.

Two, reducing the trade deficit by imposing additional tariffs or quotas would hurt the U.S. economy in many ways: inflationary forces will be increased, production costs in the downstream industries will go up and they will lose competitiveness and jobs. At the same time, American consumers will be forced to pay higher prices not only for the imported goods, but also for U.S. produced goods that can then be sold at higher prices due to a lessening of competitive forces.

Three, the preferred way to bring about greater balance in the international accounts is by the rapid removal of import barriers in countries with trade or current account surpluses. Japan with its $25 billion current account surplus is particularly well placed to liberalize its import markets significantly.

Four, only the unhampered access to export markets in industrialized countries makes it possible for the developing countries that are now experiencing debt service difficulties to earn the funds necessary to service their external debt. If export markets were to be closed to these countries, it would be impossible for them to service their debt. Especially the

countries enjoying current account surpluses, such as Japan, could do more to open their markets to exports from the developing countries.

Five, it is highly desirable that any exchange rate change take place in a gradual fashion. It is well known that it takes between one and two years for exporters to adjust to a change in relative prices. In the meantime, a depreciation of the dollar will drive up import prices immediately and therefore result in higher total payments for imports in the short run. Due to this J-curve effect, a sharp decline in the exchange value of the dollar would at first exacerbate -- rather than ameliorate -- the existing trade and current account deficit.

In sum, I believe that overall the strong dollar has been beneficial rather than harmful to the United States. Our current export problems stem more from the stagnant economic conditions abroad rather than from the strength of the dollar. The proper remedy is a rejuvenation of foreign economic growth rather than the imposition of import barriers that artificially depress U.S. imports below their natural level. Protectionism would be to the detriment of American consumers and many U.S. producers as well. The net capital inflows into the United States have helped to stimulate the U.S. recovery, increased our competitiveness, and created jobs for Americans. They represent a strong vote of confidence in the American economy.

Senator HEINZ. By the way, let me just say to Mr. Mendelowitz, that he knows I have been privileged to hear him testify on one other occasion before the Senate Finance Committee, and it was an excellent analysis. May I ask, in view of the lateness of the hour and my intimate familiarity with what you're about to testify on, that you summarize your remarks as much as possible, Mr. Mendelowitz.

Mr. MENDELOWITZ. I'll be happy to summarize my comments in 2 or 3 minutes and submit the full statement for the record.

Senator HEINZ. Without objection, your entire statement will be in the record.

STATEMENT OF ALLAN I. MENDELOWITZ, ASSOCIATE DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. MENDELOWITZ. We appreciate the opportunity to discuss our recent work on exchange rates. As you requested, we will comment on reasons for the dollar's continued strength and the actions and policies that have been advanced as solutions to the problems of the strong dollar.

U.S. DOLLAR'S CONTINUED STRENGTH

Although the dollar's continued strength may appear to be a contradiction in the presence of massive trade and current account deficits, it's not so surprising when viewed in the context of the broader economic environment. Exchange rates are determined by much more than just trade flows. They depend on differences between the economies and respective economic policies of different countries and expectations about the future.

The dollar's strength against other currencies comes in large part from the attractiveness of investments in the United States. U.S. demand for savings, including the demand for financing the substantial budget deficit, has exceeded the domestic supply of savings. This excess demand for savings produced high real-interest rates, and the excess demand for savings and the high interest rates on dollar investments attracted foreign capital. This, in turn, increased the demand for dollars. Although the inflow of foreign capital has kept interest rates from going even higher, the same capital flows contributed to the rise in the dollar's value.

What, if anything, can be done to move the dollar off its uncomfortable pedestal?

I'd like to offer the following general observations.

First, exchange rates may not respond symmetrically to policy changes. The fact that large U.S. budget deficits and restrictive monetary policy, together, led to a strong dollar, does not mean that a substantial cut in the budget deficit must necessarily weaken the dollar by the full amount of its appreciation over the past several years.

Second, while a weakened dollar would improve the competitiveness of U.S. industry, a falling dollar will make inflation worse. We will be required, in a sense, to pay back the earlier reduction in inflation that took place when the dollar was strengthening.

Third, it is not possible for us to offer any simple policy changes with an assurance that they will obtain specific exchange rate goals. Foreign exchange markets are too complex and too difficult to accurately predict that a policy change will produce a specific value for the dollar for a sustained period of time.

And fourth, while exchange rates may react fairly quickly to any policy changes, international trade will not react as quickly. The lag between depreciation of a currency and any subsequent improvement in the trade balance averages 12–18 months.

MEASURES TO LOWER DOLLAR'S VALUE

Several measures have been suggested for lowering the value of the dollar against other currencies and helping to improve the competitiveness of U.S. industry. The suggested measures include: First, changes in U.S. macroeconomic policies directed specifically at affecting the exchange rate.

Second, Government intervention in foreign exchange markets, ideally coordinated with other major nations.

Third, imposition of capital controls by the United States or other nations.

And fourth, greater international coordination and cooperation in setting economic policy.

None of these suggested measures holds much prospect for offering long-term benefits or success. Simply put, there are no quick fixes or simple solutions to the problem of the strong dollar. We have been taught a painful lesson as to the limits of our ability to adopt macroeconomic policies without regard to their international consequences. A solution to the exchange rate problem requires careful balancing of fiscal and monetary policies designed to attain simultaneously domestic and international goals.

Mr. Chairman, that concludes the summary of my statement.

Senator HEINZ. Mr. Mendelowitz, thank you very much for an excellent summary.

[The complete statement follows:]

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C.

FOR RELEASE ON DELIVERY
EXPECTED at 11:00 a.m.
June 6, 1984

STATEMENT OF

ALLAN I. MENDELOWITZ

ASSOCIATE DIRECTOR, NATIONAL SECURITY

AND INTERNATIONAL AFFAIRS DIVISION

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND

MONETARY POLICY

SENATE COMMITTEE ON BANKING, HOUSING

AND URBAN AFFAIRS

ON

FLOATING EXCHANGE RATES AND THE DOLLAR

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to be here this morning to discuss our report, Floating Exchange Rates in an Interdependent World: No Simple Solutions to the Problems. As you requested, we will address two principal topics: first, reasons for the dollar's continued strength on foreign exchange markets and second, actions and policies that have been advanced as solutions to the problems that the strong dollar continues to pose for American businesses.

REASONS FOR A STRONG DOLLAR

Although the dollar's continued strength may appear to be a contradiction in the presence of massive trade and current account deficits, it is not so surprising when viewed in the context of the broader economic environment. Exchange rates are determined by much more than just trade flows. They depend on differences between the economies and respective economic policies of different countries and expectations about the future. While we cannot measure the precise effect of each individual determinant of an exchange rate, we do know the general direction of causation. Briefly, those economic changes or policy developments that generate demand for a particular currency will cause the value of that currency to appreciate relative to others. Over the last several years, both underlying economic changes and specific U.S. government policies have increased the demand for dollars.

The dollar's strength against other currencies comes in large part from the attractiveness of investments in the United

States. The U.S. demand for savings, including the demands for financing the substantial budget deficit, has exceeded the domestic U.S. supply of savings. This excess demand for savings produced high real (i.e., inflation adjusted) interest rates. The excess demand for savings and resulting high rates of return on dollar investments attracted foreign capital which in turn increased the demand for dollars. Although the inflow of foreign capital has kept interest rates from going even higher, this same capital inflow has contributed to the rise in the dollar's value.

The persistence of high interest rates along with a strong dollar strongly suggest that, for fear of reigniting inflationary expectations, the Federal Reserve has not been willing to accelerate monetary growth to accommodate this excess domestic demand for credit. The dollar's strength is also a sign of widespread international expectations of low U.S. inflation, so current interest rates are high in both nominal and real terms. High interest rates and the strong dollar are, together, the reflection of both fiscal and monetary policies of the United States.

Another factor contributing to the dollar's appreciation against all other major currencies has been the general perception of the safety and stability of the investment climate in the United States. This has led to a demand for dollar investments as "safe havens."

On a bilateral basis, the exchange rate between the dollar and any particular currency reflects the differences between the

respective economies and economic policies of the United States and those of the second country. Such is the case with respect to the yen-dollar exchange rate. For example, while the United States is currently a capital importer, Japan is a natural capital exporter. For a number of reasons, Japan enjoys a surplus of savings--making capital available for overseas lending and investment. Since the 1970s, moreover, the Japanese government has been gradually relaxing controls over its financial markets. As restrictions were eased, capital flowed overseas in response to economic incentives, and as a result the yen weakened.

The dollar's strength clearly has been both a benefit and a burden for the U.S. economy. Consumers have gained greater buying power, for instance, as the strong dollar decreased the the price of imports. Also, the inflow of capital probably kept interest rates lower than they would have been otherwise. At the same time, however, by increasing the price of American products relative to foreign products, the strong dollar has hampered U.S. firms' efforts to compete with foreign firms, both domestically and in foreign markets. This year's U.S. trade deficit may exceed $110 billion according to many estimates, including those of the administration. As much as half of that deficit may result from the dollar's appreciation during the past several years.

GENERAL OBSERVATIONS

What, if anything, can move the dollar off its uncomfortable pedestal? We offer the following general observations.

--First, exchange rates may not respond symmetrically to policy changes. The fact that large U.S. budget deficits and restrictive monetary policy together led to a strong dollar does not mean, for example, that a substantial cut in the budget deficit must necessarily weaken the dollar. Such a change, by increasing confidence in the stability of the U.S. economy, could attract more foreign capital and conceivably increase the dollar's value.

--Second, while a weakened dollar would improve the competitiveness of U.S. industry, it would not be an unalloyed good. Just as a rising dollar lowered the rate of inflation, a falling dollar will make inflation worse. We will be required, in a sense, to pay back the earlier reduction in inflation.

--Third, it is not possible for us to offer any simple policy changes with an assurance that they will attain specific exchange rate goals. Foreign exchange markets are too complex and difficult to predict accurately that a policy change will produce a specific value for the dollar for a sustained period of time.

--Fourth, while exchange rates may react fairly quickly to any policy changes, international trade will not react as quickly. The lag between the depreciation of a currency and any subsequent improvement in the trade balance averages 12 to 18

months. We agree with the President's Council of Economic Advisors that the die is cast as far as the dollar's impact on the 1984 trade deficit. There is little likelihood of a dramatic improvement in the trade deficit in the near term.

--Lastly, and in a somewhat more optimistic vein, not all of the U.S. trade deficit is caused by an "overvalued dollar." An economic recovery by the United States that has been stronger than that of our trading partners has also contributed to the trade deficit. Although greater growth in other economies will not wipe out the trade deficit, international economic recovery can help to cut the U.S. trade deficit by expanding the demand for U.S. exports.

POLICY ALTERNATIVES

Several measures have been suggested for lowering the value of the dollar against other currencies and helping to improve the competitiveness of U.S. industry. I will briefly discuss several of them, including

--changes in U.S. economic policies,

--government intervention in foreign exchange markets, ideally coordinated among major nations,

--imposition of capital controls in the United States, and

--greater international coordination and cooperation in setting economic policy.

Each proposal has both potential benefits and limitations.

Changes in U.S. economic policy

It should be possible to reduce the value of the dollar by changing macroeconomic policies. However, we may find that doing so would sacrifice important domestic policy goals. For example, a policy of accelerated monetary growth might lower the value of the dollar. However, if these policies were changed only to bring about a depreciation in the dollar, it is likely that any gains enjoyed by sectors of the economy that compete with foreign producers would be offset by the losses experienced by sectors of the economy due to renewed inflation. Excessive money supply growth and an ensuing dollar depreciation would both lead to increased domestic prices. We would urge that any macroeconomic policy changes be made in response to a full complement of domestic and international concerns. Policy makers must recognize the limits that the increased openness of the U.S. economy places on the range and mix of acceptable macroeconomic policies.

Greater government intervention in foreign exchange markets

Many proposals to lower the value of the dollar call for increased U.S. government intervention in foreign exchange markets, coordinated with intervention by other major nations. There is still some disagreement about precisely how effective intervention can be. Most analysts agree, however, that it cannot be a long-term force in setting exchange rates because intervention by nations, individually or jointly, is not enough to counter the market forces that determine exchange rates. However, intervention can be effective at particular times in

bringing order to chaotic markets. This appears to be the case in the coordinated intervention by the United States, France, West Germany, Japan, the Netherlands, and Switzerland in late July and early August 1983, when extremely rapid depreciation of European currencies against the dollar was stabilized. Furthermore, while agreements among nations to intervene are necessary for coordinated intervention to succeed, nothing guarantees that several different nations will be able to agree that a particular intervention at a particular time is in their best interest.

Controlling international capital flows

By restricting capital movements in and out of a country, capital controls are supposed to limit exchange rate fluctuations or to influence the level of the exchange rate. Such controls are designed to lessen the transmission of economic disturbances across national borders by limiting economic interdependence. In restricting capital movements, however, a country foregoes some benefits of interdependence, such as greater access to overseas investments or to foreign sources of funds.

Capital controls can take several forms and can be established to favor inflows or outflows. Restricting capital outflows or encouraging inflows, for instance, would be strategies to strengthen a nation's currency. Possible techniques include making capital outflows less attractive by imposing special taxes on interest earned on foreign assets (as the United States did with the Interest Equalization Tax in the 1960s) or restricting bank loans to foreign borrowers. A currency could

be weakened by encouraging capital outflows or discouraging capital inflows. For example, net capital flowing to the United States might be reduced if additional taxes were placed on interest payments made to foreigners.

If capital controls are successful in changing currency values, they may exact a cost elsewhere in the economy. For example, if capital inflows are restricted with no accompanying change in the domestic demand for or supply of savings, interest rates will tend to rise. Exports may be encouraged and imports discouraged, but the whole economy may bear a cost in the form of higher interest rates.

Some arguments for capital controls are noneconomic in origin, however. Nations frequently restrict or regulate direct foreign investments in several types of industries, such as defense, atomic energy, radio and television broadcasting, and mineral development. In such cases, nations decide that foreign ownership is not acceptable and that the benefits of capital controls are worth the cost.

Coordinating national economic policies

Finally, few observers believe that increased intervention or other policies that do not deal with fundamentals can resolve the difficulties frequently attributed to exchange rate behavior. Increased intervention in foreign exchange markets would only substitute a short-term solution for what many observers find to be the real problem--uncoordinated or imprudent national economic policies.

It has been known for a good number of years that nations could avoid many international economic problems by better coordinating their economic policies. However, no one has yet found a way to achieve more effective coordination. Nations pursue policies that they perceive to be designed to advance their individual national interests. Even when there is a formal structure for defining common interests and a stated commitment to coordinated policies, as in the European Economic Community, subordinating domestic concerns to achieve common objectives is exceedingly difficult for a national government.

Nations do exchange information on current economic conditions and policies. This shared information can be the basis for recognizing the constraints on policies in an interdependent world economy. In the final analysis, however, each nation must define its own long-term political and economic interests and adopt policies designed to satisfy those interests, recognizing that every other nation has the same responsibility for the welfare of its own citizens. Interdependence among national economies, however, constrains the range of policies that a nation may successfully adopt. Implementing economic policy without recognizing how interdependence influences the outcome of that policy can disrupt foreign exchange markets and, in turn, prove costly to the economy.

CONCLUSIONS

Simply put, there are no quick fixes or simple solutions to the problem of the dollar. We have been taught a painful lesson as to the limits of our ability to adopt macroeconomic policies without regard to their international consequences. A solution to the exchange rate problem requires a careful balancing of fiscal and monetary policies designed to attain simultaneously domestic and international goals.

Mr. Chairman, this concludes my prepared statement. I will be happy to try to answer any questions you may have.

Senator HEINZ. Mr. Heller, I was fascinated by your analysis of the international capital flows. You said that our imports of capital really remained the same at $80 billion a year, it's just that our outflow has been lessened. That really directly contradicts the spirit of what Mr. McNamar was saying. He was saying the dollar was strong because the United States is such a great place for everybody to put their money. What you've said is there really hasn't been any change, that Americans are just keeping their money at home, because they like the investment opportunities or the high interest rates or the deregulation of interest rates on deposits, and so forth.

Do I understand you correctly, that you disagree strongly with Secretary McNamar's analysis?

$80 BILLION INGRESS OF FOREIGN CAPITAL

Mr. HELLER. I don't think so, Mr. Chairman. We're talking about more than $80 billion in foreign capital that are flowing every year into the United States——

Senator HEINZ. But the implications of his remarks have been that we are getting more from abroad, and you stated that we have the same amount.

Mr. HELLER. I would say it's stable at a very high level. Talking about an $80 billion capital inflow gross amount is certainly no pittance, and I believe even the U.S. Treasury would argue that that is a very large amount of money indeed.

Senator HEINZ. Is that high by historical standards?

Mr. HELLER. Oh, yes.

Senator HEINZ. Aha!

Mr. HELLER. At that plateau, it's the highest it has ever been. In 1981, we reached a peak. In 1982, it fell slightly. In 1983, it was down again. And now I think it's picking up just slightly again.

Senator HEINZ. But you would agree that we have a strong currency and that it has many of the effects that Mr. Bergsten pointed out?

Mr. HELLER. I think Mr. Bergsten—if I may disagree with him a bit here—he's looking at it in a partial equilibrium framework. Other things equal, he analyzes what is the effect of the U.S. trade balance being in deficit, and I agree with him. If everything else would stay exactly the same, and we could eliminate the trade balance, yes, there would be certain beneficial effects going to the U.S economy. But you're not able to hold other things equal. For instance, you would forgo the beneficial effects of the capital inflow into this country. And I find it somewhat ironic that many people around the world bemoan the fact that many developing countries, for instance, are no longer benefiting from the capital inflows that used to flow into these countries and help them grow. And now when the capital inflows take place in this country, it's supposed to be something bad. I think it helps our country to achieve a higher rate of growth, and indirectly, the whole rest of the world benefits.

Senator HEINZ. If we are achieving all of that without large budget deficits, I could agree with you, but do you have any fear that there's going to be a day of reckoning?

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Mr. HELLER. Well, there's always the day of reckoning when you have to pay back the funds that you have borrowed earlier. The key question is whether you have invested them in the meantime in productive endeavors or not.

Senator HEINZ. Are we?

Mr. HELLER. Overall, we are doing very well. We are growing at a very rapid rate in this country——

Senator HEINZ. Oh, no. I asked about investing in productive endeavors.

Mr. HELLER. Well, I don't think the Federal Government is doing that great a job in investing——

Senator HEINZ. No, I mean the country as a whole.

Mr. HELLER. The country as a whole, certainly, yes.

Senator HEINZ. How do you know that?

Mr. HELLER. There are 6 million new jobs since 1980. That's the strongest performance——

Senator HEINZ. Maybe that's just consumption. We're talking about investment. If you are operating at 40-percent capacity utilization, and consumers start spending money, you can get a lot of people employed.

Mr. HELLER. That's true, until you have picked up that slack, that idle capacity, and you've put those unemployed workers back to work.

Senator HEINZ. You intimated that we have made some good, smart, long-term investments in this country in the last 3 or 4 years, and I'd like to know what the evidence of that is. Certainly, if more people are employed, I'm glad to see that, but is that the same thing as productive long-term investment that's going to make the country more competitive, avoid inflation, and sustain economic growth?

Mr. HELLER. I think we have done some terrific investments in recent years. If I look around California, especially. Silicon Valley, one of the booming areas in the entire world, and I wish the rest of the country were in exactly the same spot.

Senator HEINZ. Well, the point is, it's not. What characteristics does Silicon Valley have, in terms of the investment that's being made there, in comparison to investments being made anyplace else? There's some statistical evidence to suggest that very short-term investments are very popular these days, because interest rates are very high.

SHORT-TERM INVESTMENTS

Mr. HELLER. Well, Mr. Chairman, you've been talking about these short-term investments several times.

Senator HEINZ. Yes.

Mr. HELLER. I think that is also evidence of the great rate of technological progress that we have, not only in this country but also abroad. I don't think you will be able to see again, investments that will be there for 30 years, and at that particular time will still be competitive.

Senator HEINZ. How about 10?

Mr. HELLER. Well, some things will even change faster than 10 years. Think of the computer generation that we had 10 years ago;

it's totally outmoded according to today's standards. So you will get a faster rate of turnover in much of the technological equipment that we have in place. And therefore, you have shorter periods that you are looking at.

Senator HEINZ. But are we building industrial capacity, short or long term, at the rate at which we need to build it?

Mr. HELLER. Well, it's a relative question, I think what you're saying. At the rate at which we need to build, in order to do what? So that's a difficult question to answer.

Senator HEINZ. Well, it's a central question, for this reason. When you get up to 80-percent operating capacity, the 81st and additional percentiles tend to be very high cost, and one of two things happens. Either you increase imports, because the additional demand results in increased imports, because no one can produce things at a price low enough, or if there are not increased imports, you get inflation. And if you get more imports, you get to the point where people are saying, Gee, that country has such a big debt overhang, we don't want to sell them anything, and we don't want to hold their currencies, and then you have the Argentinian or Brazilian situation. But you don't see a risk of that?

Mr. HELLER. No. I think we are changing now. I mean the stage that we are in in our recovery, we are finished with the fairly exuberant change period where we were taking up slack. We are now in a more mature phase of the recovery, and I think it is very important for us that investment in this country increases.

Senator HEINZ. I would agree with you. The statistics I've seen seem to indicate that the capital goods sector, partially because of import replacement, but partially because it's not really as healthy as it normally is at this phase in expansion, isn't doing what we need, in order to sustain an expansion.

Do you agree or disagree?

Mr. HELLER. Well, it depends whether you are looking at absolutes or relatives.

Senator HEINZ. I'm talking about continued economic recovery. You can call that an absolute or a relative. I'm just asking the question.

Mr. HELLER. As far as the percentage increase in investment is concerned, the percent increase is ahead of what is typical for recoveries at this particular stage.

Senator HEINZ. Well, the leading percentages aside, do we have enough to have sustained economic expansion?

Mr. HELLER. I think we have to do more.

Senator HEINZ. More what?

Mr. HELLER. More investment.

Senator HEINZ. Can we do it at interest rates, real interest rates, where they are today?

Mr. HELLER. It's very difficult.

Senator HEINZ. So what should we do?

Mr. HELLER. Well, one suggestion has been made by, I think, Representative Crane to make interest rates no longer taxable—to cease the taxation of interest rates, which is so unique in our country compared to the European countries, for instance.

Senator HEINZ. Well, he better have a talk with Danny Rostenkowski quick while they're still in conference. [Laughter.]

Fred, let me ask, do you take the relatively low-key view that Mr. Heller does that we could have a problem, but, things will work out?

Mr. BERGSTEN. No. I think what Mr. Heller, the Treasury, and other apologists for dollar overvaluation and the massive trade deficits forget is the sustainability of the situation. In the short run, there are some benefits of the type that Mr. Heller outlined in his statement. But what these apologists are really saying is that the United States can permanently shift its comparative advantage. It can give away much of its manufacturing industry and other tradable goods, in return for a comparative advantage in the financial sector—selling pieces of paper, to put it in a perjorative way, but one that makes the point.

What they're saying is that we can indefinitely run trade deficits on the order of $100 billion plus, attract capital inflow to offset that, build our net debtor position toward a half a trillion, $1 trillion—they never said when it can stop or when it should stop or when it must stop. It just seems to me, that on the face of it, that is unsustainable and undesirable. So I would take a much higher key view, as mentioned in my statement, and suggest that some things be done about, even if those aren't always things that we economists regard as particularly palatable.

Senator HEINZ. Senator Proxmire.

JAPANESE YEN/DOLLAR ISSUE

Senator PROXMIRE. Mr. Bergsten, Mr. McNamar, who just testified, in his testimony referred to the recent agreement with the Japanese on the yen/dollar issue and said, "The long-run result should be a significant strengthening of the yen." In referring to that same agreement, you say on page 4 of your prepared testimony, and I quote, "The recently announced United States-Japan 'yen agreement' will make the problem worse, at least in the short run, by encouraging more capital outflow from Japan."

Can you explain your disagreement with Mr. McNamar on this issue, or whether, if you don't agree, what could the long run of that he refers to be?

Mr. BERGSTEN. I disagree with him sharply in the short run and probably in the long run. In the short run, liberalization of the Japanese capital market means much more reduction in their current limitations on capital outflow than on capital inflow, the reason being that most of the remaining Japanese restrictions are really on capital outflow. So if they do liberalize along the terms of the agreement that was announced last week, there will be more capital outflow from Japan, that is, borrowing in Japan by foreigners. That will further reduce the value of the yen, undervalue the yen more against the dollar, make their trade position stronger and our trade balance worse.

That's why I disagree in the short run.

Senator PROXMIRE. Let me just interrupt to ask, didn't the Japanese liberalize the outflow of capital 3 or 4 years ago?

Mr. BERGSTEN. Yes. And that is one of the reasons for the problem we have today. Your memory is very good, because I used to

talk about that a couple of years ago when we discussed the matter here in the committee.

The Japanese did a major liberalization in late 1980. Clearly, the major effect of that was just what I said would happen more now. It pulled down the barriers on capital outflow, and that was one of the reasons why the yen has been so weak against the dollar for the last 3 or 4 years and made the trade problem so severe. What we're going to get now, albeit to a lesser extent, is more of the same in the short run.

For the longer run, I also doubt the Secretary's forecast, though there one, I must admit, can be less certain. I think history is not on his side. I have studied quite a lot the international use of natural currencies—the dollar, sterling historically, the deutsche mark, which is the most relevant case over the last 5 or 10 years. What you find is that, as a national currency is becoming internationalized, there is, to be sure, a buildup of foreign holdings of that currency which will, other things equal, push the exchange rate of that currency up. But once that stock of currency is held and circulating around the world, it can also be sold off rather quickly. Indeed, one of the reasons the dollar got so weak in 1978, was the dollar overhang was sold off in favor of deutsche marks and other currency.

Right now, the deutsche mark's weakness is partly explainable by the selloff of the same deutsche mark holdings that were built up in the late 1970's when the dollar was weak. So what you get over time is an increased volatility of the exchange rate.

Senator PROXMIRE. It could go either way.

Mr. BERGSTEN. Over time, the record is that the trend kind of stays largely unchanged, based on underlying fundamentals. You get greater volatility, so that you may get a stronger yen in some periods but you're likely to get a weaker yen in other periods. I don't see any net gain in competitive terms on that account.

Senator PROXMIRE. Mr. Heller, I was struck by the fact that in discussing reasons for the dollar's high value, you made no mention of the budget deficit. In contrast, Stephen Roach, a vice president of the Morgan Bank, testified before the Finance Committee on March 23 that the budget deficit, the dollar's high value and the trade deficit are intimately related to each other.

Is Mr. Roach wrong?

Mr. HELLER. No. I fully agree with him, Senator Proxmire. About 3 weeks ago, I had the opportunity to testify before the Joint Economic Committee, and I looked in quite some detail at the linkage between the Federal deficit and the trade deficit, and indeed, there is a relationship.

I'll be happy to submit that for the record, if you wish.

Senator PROXMIRE. Will you do that for the record? I'll appreciate it. I know that the time is late, and I appreciate your limited response.

[The following information was subsequently supplied for the record:]

Foreign Trade and the Balance of Payments: Cyclical Adjustment, Structural Problem, or Policy Dilemma ?

Statement by
H. Robert Heller
Vice President for International Economics
Bank of America N.T.& S.A.

before the
U.S. Congress
Joint Economic Committee
Washington, D.C.

May 1, 1984

Foreign Trade and the Balance of Payments: Cyclical Adjustment, Structural Problem, or Policy Dilemma ?

The rapidly rising U.S. trade deficit has reached record levels in recent months. For the policy maker it is important to ascertain whether the trade deficits will be reversed automatically over the course of the business cycle or whether structural factors will lead to a continued worsening of the situation. These questions are important because they have a direct impact on the viability of the recovery and influence the range of options open to the policy makers.

Some observers blame the large U.S. trade deficit on the strength of the U.S. recovery and nigh U.S. interest rates. By this they stress the cyclical causes of the trade deficit. While these factors are certainly of some importance, they do not tell the whole story. A good argument can be made that structural influences are at least as important in causing the rising trade deficits. To focus exclusively on the predominantly cyclical factors will lead to an improper diagnosis of the problem and therefore to inappropriate policy prescriptions.

But before trying to pinpoint individual causes of the trade deficits, it is appropriate to consider the larger economic interrelationships between the trade imbalance, the governmental deficit, and the connection between domestic saving and investment. Changing any one of these parameters will have

important feedback effects on the other parameters. Therefore, only a broad framework that takes all the interrelationships into account will lead to the appropriate policy prescriptions.

It should also be borne in mind that while the trade imbalance has a physical or real dimension to it, it are the financial flows that provide much of the linkages and feedback effects important to an analysis of the trade deficit. In my remarks I will therefore focus mainly on the financial consequences of the trade imbalance.

1. The Federal Deficit and the Trade Deficit

It is useful to examine the relationship between the federal deficit and the trade deficit in a flow-of-funds framework. This accounting framework juxtaposes all sources of income in the American economy and the uses of the income earned. Americans derive their income from consumption expenditures by others, governmental spending, investment expenditures, and purchases by foreigners, that is, U.S. exports. They spend their income on consumption goods, taxes, saving, and imports. Obviously, expenditures on consumption by one group of people are equal to income earned by others from these consumption expenditures. This leaves the governmental sector, the saving-investment relationship, and the foreign sector to be considered.

The government deficit will have to be financed by a foreign

capital inflow or an excess of domestic saving over investment. Thus, the government deficit can be financed only by a crowding out of domestic investors, an increase in domestic saving, or an increase in net foreign capital inflows — which implies an increase in the trade deficit or, more appropriately, in the current account imbalance.

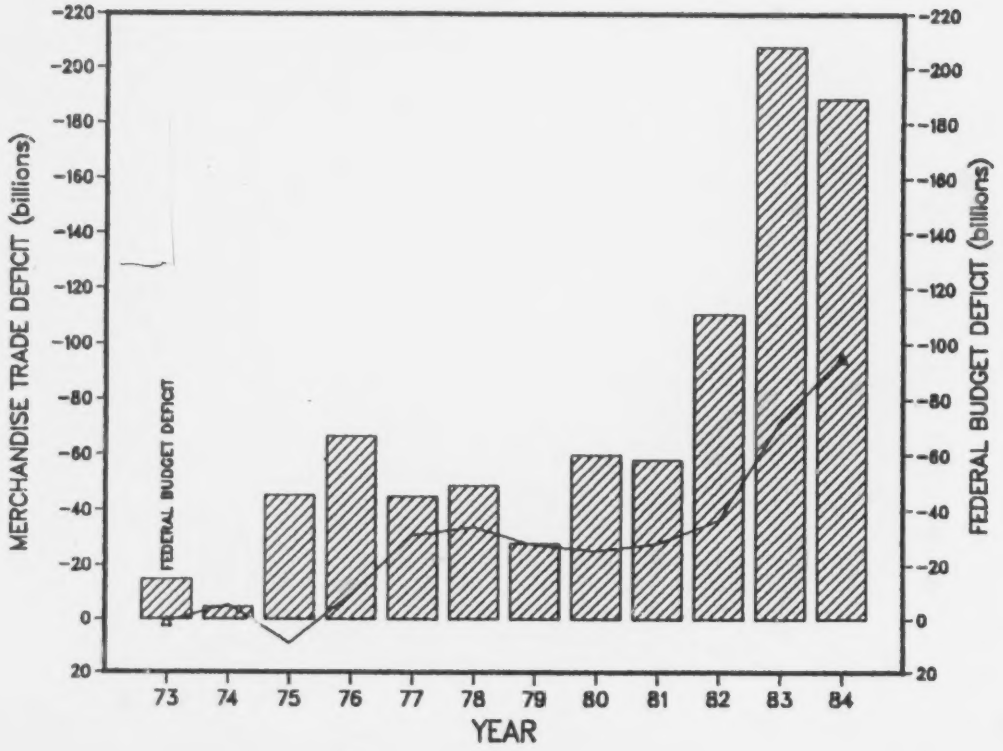
Figure 1 shows that the trade deficit has mirrored the development of the federal budget deficit during the last decade. If the trade deficit were eliminated somehow or other, say through a sharp depreciation of the dollar, it follows that foreign capital inflows would also be in balance and that the entire federal deficit would have to be financed from domestic sources. This undoubtedly would drive up domestic interest rates even further, a point to which I would like to return later.

In contrast, there is little doubt that a reduction in the federal deficit would help to reduce the trade deficit. By reducing the federal financing requirements, more funds would be available for domestic investment and/or a smaller net foreign capital inflow into the U.S. would be needed.

The key question is how the reduction in the federal deficit should be achieved: through tax increases or through spending restraint. Tax increases would further burden the U.S. private sector and reduce its international competitiveness by imposing additional costs on workers and entrepreneurs. This would make it

Figure 1

FEDERAL AND TRADE DEFICITS



harder for Americans to compete in the international marketplace.

The preferred way to reduce the federal deficit is therefore to enact spending cuts or, at the very least, a freezing of current spending levels. These actions will free domestic resources that can be used to create new jobs or to make old jobs more productive and competitive. This greater competitiveness will soon be reflected in more exports and the continuing economic expansion will reduce the need for governmental spending on unemployment and welfare programs. Everone would be better off.

Just like it has proven elusive to separate the cyclical and structural components of the federal budget deficit, a clear separation of cyclical and structural components of the trade deficit is also difficult to achieve. The relationship between the federal budget deficit and the trade deficit makes this abundantly clear.

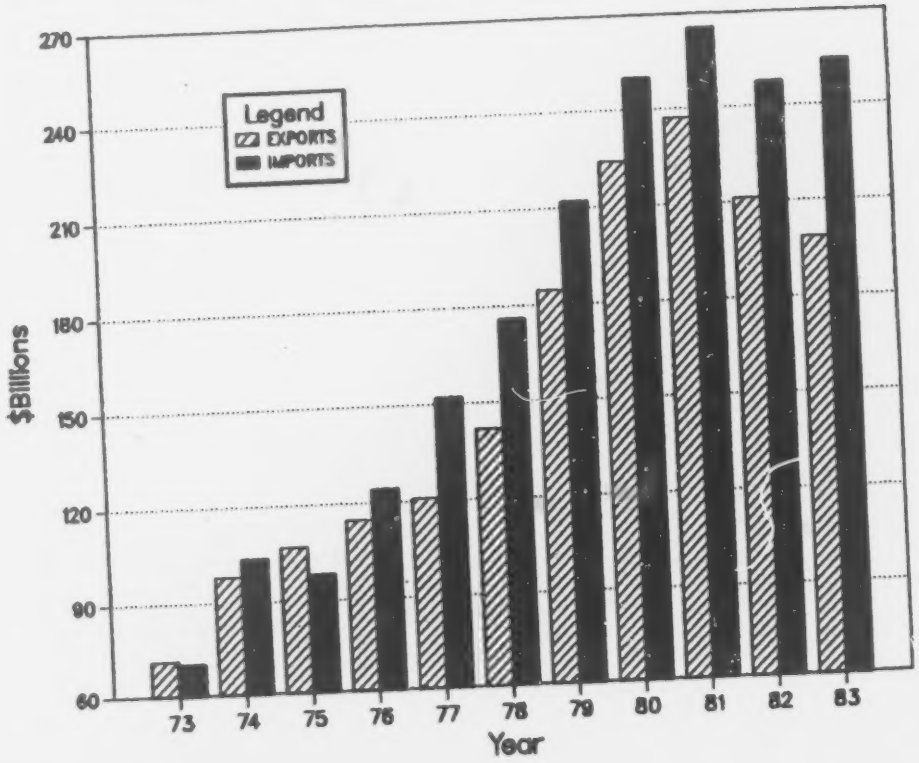
2. Economic Activity and the Trade Deficit

It has been argued that the trade deficit is mainly due to a surge in imports accompanying the strong U.S. expansion. This is questionable.

Figure 2 shows that the record merchandise trade deficit of $58 billion in 1983 was not primarily caused by a surge in U.S.

Figure 2

U.S. Merchandise Exports & Imports



Note: 1983 first three quarters at annual rates.

imports as the U.S. recovery got under way. In fact, in 1983 U.S. imports of $258 billion were below the peak of $261 billion registered in 1981.

Instead, the record trade deficit can be traced to a sharp decline in U.S. exports from their peak of $234 billion in 1981 to $201 billion in 1983. The export declines were concentrated in Latin America, where debt repayment problems and governmental austerity programs drastically curtailed import spending. U.S. exports to Latin America dropped by some 40 percent between 1981 and 1983. U.S. exports to the other industrialized countries have stagnated since 1980.

We may conclude that the depressed level of U.S. exports rather than a surge in U.S. imports is a key factor in explaining the trade deficit. Cyclical and structural factors in other economies have therefore at least as much impact on the U.S. trade deficit as the cyclical situation in the U.S. alone.

This finding has important implications for trade and economic policy. Clearly, it would be inappropriate to artificially depress U.S. economic activity to hold down imports. Similarly, it would be improper to impose further artificial import barriers to reduce the level of U.S. imports below their natural level.

Instead, economic activity abroad needs to be rejuvenated and barriers to U.S. exports in other countries be reduced. Countries

in a balance of payments surplus position, such as Japan with its $25 billion current account surplus, are particularly well placed to remove their import barriers. By this they would not only contribute to a better balance in international payments, but also help to perpetuate the global recovery and benefit their own consumers.

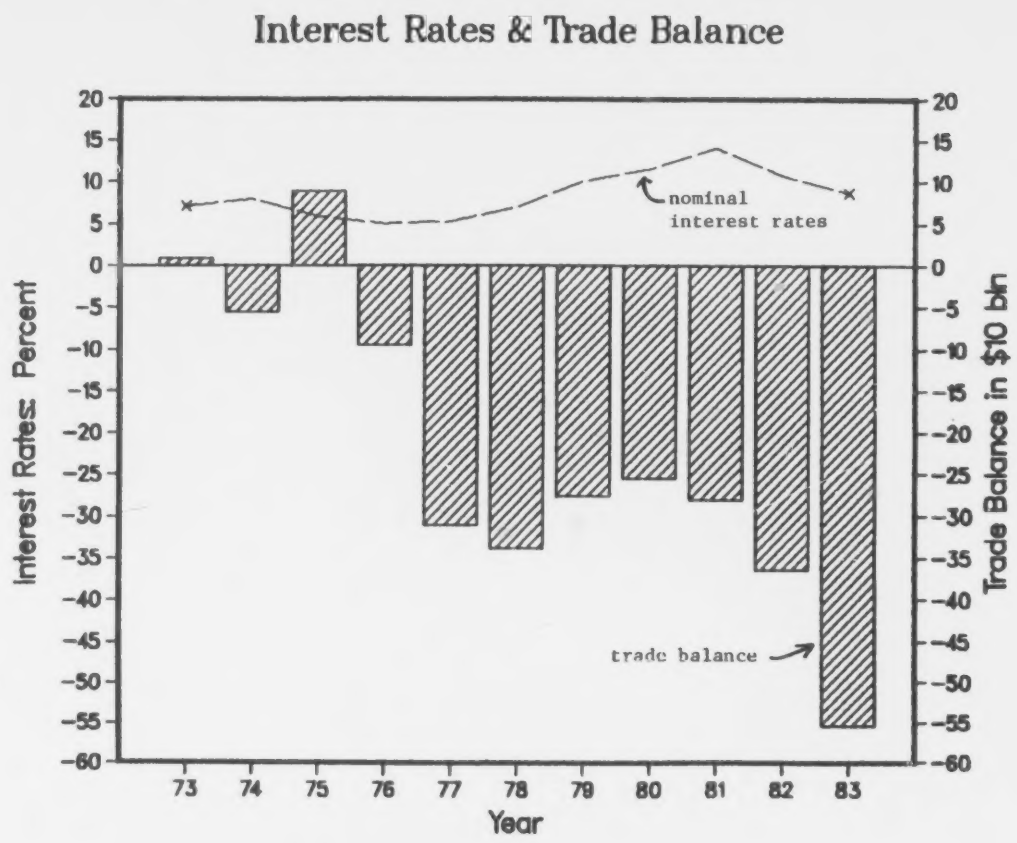
3. Interest Rates and the Trade Deficit

It has been argued that U.S. interest rates are abnormally high and that they induce foreign capital inflows into the United States. The argument continues that due to the arithmetic of double-entry bookkeeping, the capital account surplus has to be balanced by a deficit in the current and trade accounts.

While theoretically conceivable, this argument is doubly flawed on empirical grounds. First of all, as Figure 3 shows, interest rates have come down sharply from their peaks in 1981, while the trade deficit has mushroomed since then. Also in prior years it is difficult to discern a systematic relationship between interest rates and the trade deficit.

Second, foreign capital inflows into the U.S. peaked in late 1981 and continued to decline in 1983 from their 1982 levels. For instance, in the first three quarters of 1983, foreign capital inflows into the U.S. were running at an annual rate of $61 billion, which was considerably below their 1982 level of $88

Figure 3



Note: 1983 first three quarters at annual rates.

billion.

Rather than attracting increasing amounts of foreign capital, the United States has been lending and investing less abroad. The U.S. capital outflow has been cut sharply from $118 billion in 1982 to $38 billion in 1983 (first three quarters at annual rate). The U.S. is not pulling in more foreign capital, but is keeping more funds at home.

Some observers have deplored this tendency and have argued that the United States stands to become a net debtor nation to the rest of the world. This is considered undesirable both on the ground that it will impose additional debt service burdens on the U.S. economy and that it is inappropriate for one of the wealthiest countries in the world to be a net user of foreign capital. Clearly, both arguments cannot be right at the same time. If foreign debt always constitutes a net burden, poor countries are obviously not better placed to carry this burden than rich countries. It is therefore appropriate to examine these points in some greater detail.

4. International Indebtedness and the Trade Deficit

At the end of 1982, the United States had $834 billion in foreign assets and foreigners had invested $666 billion in the United States, for a net investment position of $168 billion in favor of the United States. By the end of 1983, this net investment

position had eroded to approximately $125 billion, and it became clear that by the end of 1985 the U.S. net international investment position might erode to zero, if current trends continue.

Several observations are in order. First of all, the United States is at the present time the most vigorous major economy in the world. It is therefore natural that Americans invest their resources at home and that foreign funds flow into the U.S. in order to benefit from and to participate in the economic resurgence under way here. A cyclical investment boom is now gathering strength.

Second, the deregulation of large sectors of the American economy has provided new opportunities for domestic and foreign investors that did not exist before. Consequently, more American capital is staying at home and foreign capital is being invested here for strategic and structural reasons.

The financial sector in particular has benefited from the deregulation process still under way. Foreign banks see new opportunities in the United States, and American financial institutions are eager to broaden the geographic and product diversification of their financial services.

Third, international lending by U.S. banks abroad has been curtailed sharply due to the increasing regulation of

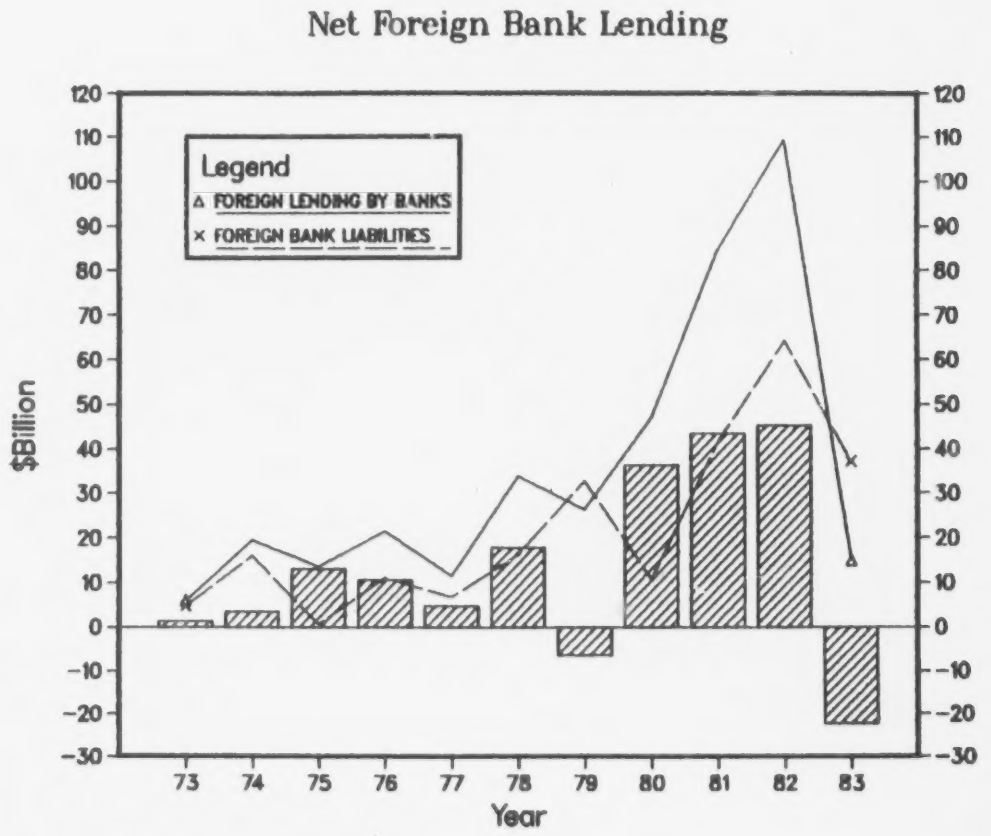
international banking activities, the debt service difficulties of many developing countries, and the depressed economic conditions abroad.

All these factors have combined to reduce total foreign lending by U.S. banks from $109 billion in 1982 to $15 billion in 1983 (first three quarters at annual rate) as shown in Figure 4. While U.S. bank lending abroad used to contribute greatly to the enhancement of the net U.S. international investment position, this situation has been reversed in 1983, with U.S. based banks sharply curtailing their international lending activity.

As a consequence, the net foreign investment position of the United States is deteriorating rapidly. However, one cannot have both a decreased U.S. bank exposure abroad and an increase in U.S. foreign assets in order to bolster the U.S. foreign investment position. Any action taken to reduce U.S. bank exposures abroad will -- pari passu — reduce the U.S. foreign investment position.

It would be difficult indeed to discern whether the slowdown in foreign lending by U.S. banks is mainly due to cyclical or structural reasons. Undoubtedly, both play a role. The cyclical strength of the U.S. economy makes more money stay at home, and the lack of a strong resurgence of the world economy also contributes. But the structural factors mentioned, such as new U.S. legislation and regulatory requirements, and the severe

Figure 4



Note: 1983 first three quarters at annual rates.

structural adjustment problems faced by many foreign countries undoubtedly also have an important impact on U.S. bank lending abroad and by this on the U.S. balance of payments situation in general.

5. Exchange Rates and the Trade Deficit

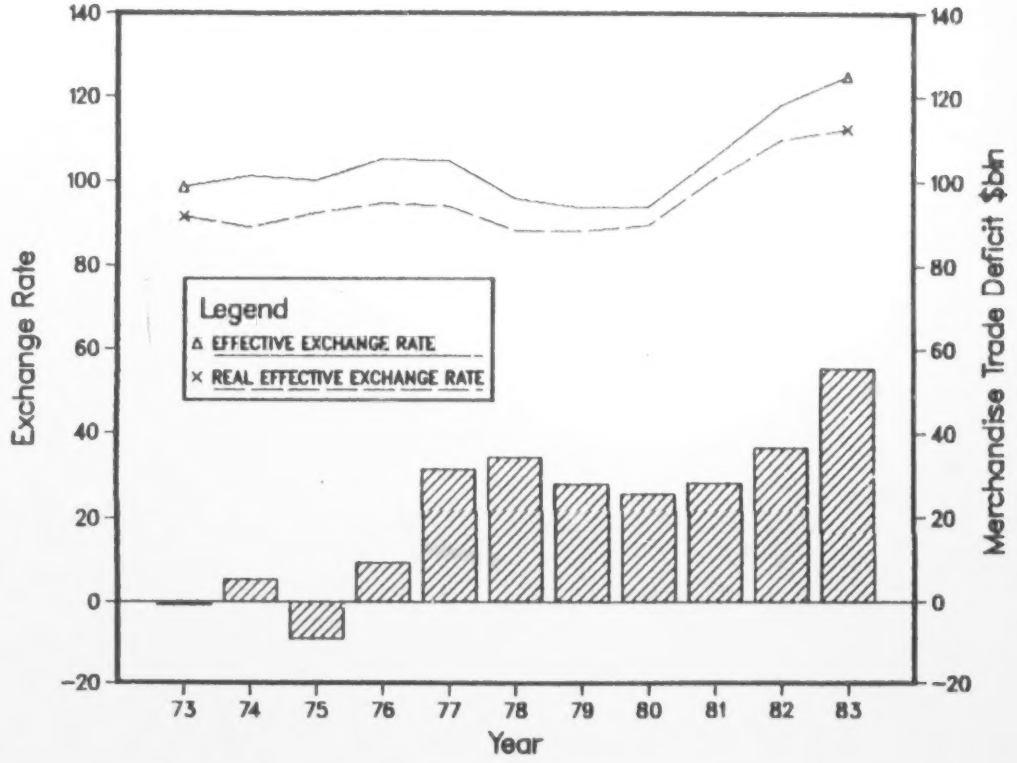
Excnange rates clearly do have an influence on the competitiveness of U.S. industry abroad. The current overvaluation of the dollar on fundamental grounds has made it more difficult for American firms to compete in foreign markets.

In 1978-80, the value of the dollar reached a low point as shown in Figure 5. This is true for both the trade-weighted and the real effective exchange rate, which takes into consideration not only multilateral exchange rate movements, but also the impact of differential inflation rates among nations. In 1980, the U.S. merchandise trade deficit amounted to $20 billion. Since then, the dollar has appreciated and the trade deficit has increased. This evidence points to a significant relationship between the exchange rate and the trade balance due to the influence of the exchange rate on the competitive position of the United States.

However, one should exercise caution in arguing that a depreciation of the dollar would immediately resolve all our trade problems. First of all, it would take one to two years before any

Figure 5

Exchange Rates & Trade Deficit



Δ Base Year = 1975

X Base Year = 1980-82

change in the exchange rate would have a beneficial effect on the trade balance. Due to the familiar J-curve effect, payments for our imports would soar as each dollar would buy less and less foreign goods and the trade balance would deteriorate until the improved export competitiveness would begin to turn the balance.

Second, a depreciation of the dollar would tend to make imported goods more expensive and might well rekindle inflationary forces in the U.S. economy.

Third, as the dollar depreciation would bring the current account into balance, the international capital position of the U.S. would also be balanced. That is, we would no longer be able to finance part of the federal budget deficit from international sources and all the funds would have to be raised domestically. This might crowd out domestic investment more than now and lead not only to higher U.S. interest rates, but might also affect the U.S. recovery adversely.

We may conclude that under current circumstances a substantial dollar depreciation might well turn out to be a mixed blessing. The best that one might hope for is a gradual decline of the real exchange value of the dollar that allows sufficient time for adjustment of the trade sector and a concommittant balancing of the federal budget deficit.

6. Accounting Errors and the Trade Deficit

One cannot close a discussion of our trade deficit problems without referring to the very large statistical discrepancy that has not only been characteristic of the U.S. balance of payments accounts, but also of the global balance of payments. In 1983, the statistical discrepancy in the U.S. balance of payments was $41 billion, and was by this almost as large as the merchandise trade deficit.

There is some reason to believe that the bulk of the unrecorded transactions is due to an underrecording of receipts of service items such as reinvested earnings abroad, investment income, and fees. Consequently, the U.S. current account deficit, if measured properly, is likely to have been substantially smaller than indicated by the officially reported data. Thus it is entirely possible that the U.S. was in substantial current account surplus in 1983.

It is important to keep these statistical problems in mind when one designes and implements policies that are intended to rectify an alleged imbalance that may in fact not even exist. Such misguided policy actions might do more damage than good. Consequently, it is important to proceed with circumspection and caution in this area due to the large uncertainties affecting the data that present the basis of the analysis.

7. Conclusions

In summary, it is a very difficult task indeed to determine how much of the U.S. trade deficit is caused by cyclical factors on the one hand and by structual factors on the other hand. However, it is certain that structural factors do play a major role in the current trade imbalance. The mere passage of time and a more balanced cyclical economic situation alone will therefore not eliminate the trade deficit.

First of all, there exists a direct link between the size of the federal budget deficit and the international balance of payments. The high federal financing requirements are directly reflected in high and rising trade and current account deficits. To the extent that the federal deficits are structural in nature, the trade deficits have a structural component as well.

Second, the U.S. trade deficit is not primarily due to a surge in U.S. imports accompanying the U.S. recovery, but due to a fall in U.S. exports. Actions designed to stimulate economic recovery abroad and to remove existing trade barriers to U.S. goods are preferable to further U.S. import restrictions intended to rectify the trade imbalance. That is, policy actions designed to eliminate existing structural barriers are indicated.

Third, it is not true that high U.S. interest rates have led to a surge of foreign capital inflows into the United States. Instead,

the positive balance on capital account is primarily due to a sharp curtailment of U.S. bank lending abroad. This slowdown in bank lending undoubtedly has both structural and cyclical components.

Fourth, while many observers wish to see a further increase in the net U.S. international investment position abroad, it is not possible to achieve this goal when at the same time U.S. lending abroad is being discouraged and curtailed. One cannot have an increase in foreign assets and a decrease in international exposure at the same time.

Fifth, the current overvaluation of the U.S. dollar has hurt the competitiveness of American exporters. However, little can be gained by a sharp and precipitous drop in the exchange rate. Instead, a gradual and smooth exchange rate adjustment is to be preferred.

Sixth, the U.S. balance of payments statistics are subject to very large statistical discrepancies and reporting errors. Caution is therefore needed in the design of policy measures based on the reported data.

Overall, we may conclude that there is little reason to believe that a better cyclical constellation of the various economies would significantly curtail or even eliminate the U.S. trade deficit. Instead, structural adjustment measures are called for both in this country and abroad. The thrust of these structural adjustment measures should be designed to eliminate existing structural imbalances, such as the federal budget deficit, and to take steps to reduce or eliminate other barriers to adjustment, so that market forces can again play their proper role in bringing about equilibrium in the international accounts.

COOPERATION OF THE JAPANESE

Senator PROXMIRE. Mr. Mendelowitz, as you know, there has been concern expressed in this country that the Japanese Government has deliberately engineered an undervalued yen to enhance its international competitiveness. The GAO's recent report on exchange rates found no support for such charges.

Has that conclusion in your report received wide acceptance, or is that issue still being disputed?

Mr. MENDELOWITZ. The impression I am under is that the consensus is growing that, in recent years, the Japanese have not deliberately tried to undervalue their currency to gain a competitive advantage. When the debate was beginning anew back in 1982, as the yen reached its recent low point against the dollar, the charge of yen manipulation was made quite often. I think our report, reports from the Council of Economic Advisers, and private studies, have all tended to support the conclusion that, in fact, deliberate yen undervaluation has not been the cause of the yen's recent value.

Senator PROXMIRE. Do you accept that, Dr. Bergsten?

Mr. BERGSTEN. I do. In fact, one could go even further. Over the last 2 to 3 years, the Japanese have intervened very heavily in the exchange markets to keep the yen from being even weaker. So they've really cut the other way.

In addition, I think Japan has kept its internal interest rate structure at least 2 percentage points higher over the last couple of years than called for by domestic Japanese considerations, in order to avoid weakening the yen and triggering more protectionist pressures against Japan.

So I think in this situation they've really cut the other way. I would add, perhaps to buttress my credibility in saying that, in 1976 I caught them redhanded, when they were manipulating the yen. They were intervening massively to keep the yen from rising, putting the money in their hidden reserves, not accounting for them publicly, and thus violating very substantially the rules of the floating exchange rate game.

I think they learned that was a mistake. In addition to the shortcoming in our own policies here, it brought on the enormous crisis of 1977–78, and I don't think they're going to do that again.

Senator PROXMIRE. And you think that for the last 8 years they have not manipulated the yen to make them more competitive?

Mr. BERGSTEN. I haven't seen anything since 1976, and in this latest period of yen weakness, they've cut the other way. There's an interesting fact you ought to realize. The yen is clearly undervalued against the dollar. In the last 3 months, the yen has hit record highs against the European currency. The yen has been at an all-time record high against the deutsche mark, Swiss franc, French franc, partly because those European currencies are so weak but also partly because the Japanese have done things to keep their currency from being weaker.

We've got three tiers of currencies right now. The dollar is massively overvalued against everybody. The yen and sterling are somewhere in the middle, undervalued against the dollar and probably overvalued against the third tier—the mark zone in Europe,

which is weak against everybody and undervalued against everybody on any trade terms one could care to choose.

Senator PROXMIRE. Dr. Feldstein, when he testified before the Finance Committee in March, discussed the long-run impact of recent capital inflows into the country. He noted, for example, that in the future, and I quote, "The U.S. will have to give some of each future year's GNP to our creditors abroad to pay for today's excess of imports over exports."

Can you explain the impact that will have on the future standard of living in our country?

Mr. BERGSTEN. It will lower it substantially.

Senator PROXMIRE. Will lower our standard of living?

Mr. BERGSTEN. It will lower our standard of living.

We are living on borrowed time, not only in terms of the big Federal budget deficit but in terms of the trade and current account deficit. At some point—I wish I could tell you—but at some point, the dollar exchange rate will have to drop very substantially, I've suggested 25 percent or so, in order to get us back into equilibrium vis-a-vis the rest of the world. That sharp decline in the dollar means the cost of our imports rises. We get smaller earnings in terms of foreign exchange when we sell our exports.

Senator PROXMIRE. That will have an inflationary effect on our economy.

Mr. BERGSTEN. It will have an inflationary effect. Part of the inflation gains of the last 3 years, which I welcome, like all Americans, are unsustainable. They were bought by a temporarily strong dollar, and when the dollar weakens, we will pay the piper.

This is a replay of history, Senator Proxmire. In the late 1960's, we partly financed the Vietnam war and the buildup of the "Great Society" with an overvalued dollar. We had to devalue in 1971, and again in 1973. We paid the price with a delay, and when we did, we unleashed double-digit inflation and world economic uncertainty that continues to be with us.

Senator PROXMIRE. Could you give off the top of your head just a rough estimate of what difference the overvalued dollar makes in the inflation rate?

EFFECTS WHEN DOLLAR COMES DOWN

Mr. BERGSTEN. Yes. There's a well-worked out relationship. The Fed has constructed it over the last 6 or 7 years, both when the dollar went down and when it came back up. For every 10 percentage point move of the dollar exchange rate, the Consumer Price Index moves about 1½ percentage points in the other direction.

Senator PROXMIRE. Is that right?

Mr. BERGSTEN. So if the dollar comes off, conservatively by 20 percent, the Consumer Price Index in about a year, would jump 3 percentage points. But it's worse than that. As the dollar has risen in the last 3 years, the inflation rate has been carried down from about a 6-percent core rate to, say, 3 percent. When the dollar declines, we both lose the gain from 6 to 3, and we take a loss from 6 to 9. The core rate is not changed by all this, barring some indirect effects wages that I think are very modest. But you both lose the

gain and you take a loss so, temporarily, it won't be just from 3 back to 6, but it'll be from 3 up to 9.

When the dollar then hits the new equilibrium rate, you drop back to the underlying core rate of 6. So people shouldn't lose their shirts either about hitting 9.

Senator PROXMIRE. That's fascinating. Could you, for the record, give us anything that you've written or others have written on this, that I could get into, because I think it is a very interesting element that has been ignored. Almost nobody has talked about the deflationary effect—temporary deflationary effect, I should say—of the strong dollar, and the fact that we're going to have to pay for it.

Mr. BERGSTEN. We'll be publishing a study at my Institute in the next couple of months which will lay out, in detail, the effects that would inevitably occur when the dollar comes off and what ought to be done to mitigate those. But I'm afraid that's going to be a stunner when it begins to happen, as it could fairly soon.

[The following information was subsequently submitted for the record:]

The Dollar Problem

Stephen Marris
Senior Fellow
Institute for International Economics*

Statement before the Subcommittee on
Domestic Monetary Policy of the Committee on Banking and Urban Affairs of the United States House of Representatives

August 9, 1984

The continuing abnormally high level of the dollar is both a cause of, and a symptom of, a major disequilibrium building up in the world economy. This disequilibrium is primarily the result of the inconsistent mix of monetary and fiscal policies being pursued both by the United States and - in the opposite direction - by several of the other Summit countries. Unless these policies are changed there is a serious risk that the present recovery in both the United States and the rest of the world will come to an untimely end. In my view, H.J. Res. 585 points in the direction of the needed changes in United States' policies, and I therefore welcome this opportunity to testify on it.

The Role of United States' Policies

I can be brief about the role of United States' monetary and fiscal policies in causing the present overvaluation of the dollar since I very largely share the views expressed at your hearings last October/November by Governor Wallich, ex-Chairman

* Economic Adviser to the Secretary General of the Organization for Economic Cooperation and Development from 1975 to 1983.

Feldstein, Professors Stanley Black, Rudiger Dornbusch, Edward Friedman and my colleague at the Institute, John Williamson.

In an initial phase, political factors, and success in reducing inflation, played an important part in the dollar's rise. But its continuing strength can be explained most plausibly in terms of the unusual stance of United States monetary and fiscal policies. First, the expectation of continuing large budget deficits has pushed up United States interest rates relative to those in other major financial centers. Second, the attraction of these large interest differentials to foreign investors has been greatly enhanced by the Federal Reserve Board's success in convincing the markets that it is not prepared to finance these deficits through the printing press, thereby fueling a new outbreak of inflation.

Events since your last hearings have thrown interesting new light on some of the differing views on these matters expressed by those who testified at that time.

You may remember that Under-Secretary Sprinkel suggested that the main reason for high interest rates was not the budget deficit, but rather the inevitable lag between inflation coming down, and people becoming sufficiently aware and confident about this to significantly lower their expectations about the rate of inflation over the longer run. For quite a time this seemed a plausible argument, and it is still difficult to refute because there is no objective way of measuring long-run inflationary expectations. It is nevertheless striking that over the last nine months, when there has been an almost uninterrupted string

of good news on the inflation front, long term interest rates have gone up, not down, by as much as two percentage points. This strengthens the case for those who have been arguing that the explanation for the abnormally high level of real interest rates is to be found, not so much in high inflationary expectations, as in high interest rate expectations, generated by the anticipation of a continuing clash between an expansionary fiscal policy and a non-accomodating monetary policy.

Second, events over the last nine months have thrown further light on the debate about the link between budget deficits and interest rates. The deficit has come down, but interest rates have gone up. How come? The answer tends to confirm the views of those who have argued that the impact of public deficits on interest rates can only be determined after taking into account what is happening to the savings/investment balance in the private sector.

The table on the next page shows what happened to the balance between savings and investment in the US economy during the first year of the recovery. Contrary to the expectations of some supply siders, the ratio of gross private savings to GNP has risen only moderately, roughly in line with experience during previous upswings. At the same time the net dissaving of the public sector at the Federal, State, and local levels fell as the recovery boosted tax revenues[1]. Taking the private and public sectors together however, the increased supply of domestic savings was not nearly large enough to meet the very sharp increase in the private sector's gross investment in plant and

equipment, residential construction and increased inventories, typical of a strong recovery such as experienced over this period.

Table 1. Changes in the balance between savings and investment in the United States during the first year of the recovery

	As percent of GNP		
	1983: Q1	1984: Q1	Change
Gross private saving	17.1	18.1	+ 1.0
Less public sector dissaving[a]	- 4.5	- 3.1	+ 1.4
Plus net borrowing from abroad	+ 0.2	+ 2.2	+ 2.0
Total gross savings available	12.8	17.2	+ 4.4
Equals gross private investment[b]	12.7	17.0	+ 4.3

a. Including state and local governments.

b. Small differences due to rounding and statistical discrepancy.

Source: Survey of Current Business, May 1984, Table 5.1.

The fact that the deficit did not come down quickly enough to make room for this sharp rise in private investment suggests that "crowding out" might have happened with a vengeance. As it was, interest rates rose; but not by enough to choke off private investment, as would have had to have been the case in a closed economy. What happened instead was that interest rates rose by enough to induce foreigners to lend increasingly large sums to the United States. Thus, of the increase of over 4 percentage points in the ratio of private investment to GNP over the last year, only a little more than one half was financed by a rise in American savings, the remainder being financed by net borrowing from abroad. The question is, of course - as pointed out by Governor Wallich and Martin Feldstein at your last hearings - how long this large scale net borrowing from abroad, which is now running at $15 to $20 billion a quarter[2], or over 2 percent of GNP, can be sustained. I will return to this question later.

There is a third element in the situation which has become more evident since your last hearings. It is now clear that as a result of the tax changes in the Economic Recovery Tax Act of 1981, and the consequences of financial deregulation, the American economy has become much more resistant to high interest rates than it was a few years ago. The ERTA raised after-tax returns on new investment by several percentage points; financial deregulation has eliminated the rationing effect which tended to cut back homebuilding at a fairly early stage in the recovery; and financial innovation, particularly in the form of variable rate mortgages, has further dampened the impact of rising interest rates on investment demand.

At first sight this seems all to the good for the American economy. It has made it possible to have a strong recovery despite high interest rates. But it is important to note that there is little evidence -so far at any rate - that these higher interest rates are going to lead to a permanent and significant increase in American savings. What has happened instead is that tax and regulatory changes have made it possible for the American economy to grow strongly at a level of interest rates sufficiently high to attract a substantial inflow of savings from abroad. However convenient this may seem, at least in the short run, as seen through American eyes, it clearly looks rather different when seen from the other end. As put rather colorfully by David Hale, Chief Economist of Kemper Financial Services Inc., with these changes in the American financial system "Florida homebuilders and California tax shelter promoters will continue to bid for savings in Osaka and Glasgow at interest rate levels that will bankrupt dollar debtors in Brazil".[3] He might now add that it could also bankrupt debtors in Glasgow, given that interest rates in the United Kingdom have risen by up to 3 percentage points since that was written.

To sum up at this point on the role of American policies. Events over the last nine months strengthen the case for those who believe that the continuing rise in the dollar -despite the adverse effects on confidence of large budget deficits and a rapidly rising current account deficit- can be explained very largely in terms of the unbalanced mix of monetary and fiscal policy, coupled with the consequences of tax changes and financial deregulation.

The Role of Other Countries' Policies

Far less attention has been paid to the important contribution which the fiscal and monetary policies of some of America's major economic partners have been making to the strength of the dollar, and more generally to the distorted pattern of savings flows in the world economy.

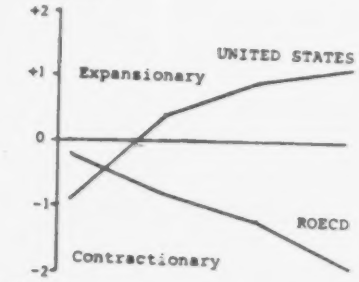
As pointed out by Professor Dornbusch in November, Japan, Germany, the United Kingdom and a number of the smaller European countries have been following fiscal policies diametrically opposite to those of the United States. Over the past three years, they have been making strenuous efforts to reduce their structural budget deficits. Indeed if one looks at the industrialized countries as a whole (what I shall call the "OECD area"), the restrictive fiscal policies of these countries have just about counterbalanced the expansionary fiscal policy of the United States. The results of this difference in policies comes out very clearly in the chart on the next page. The United States has been following a strongly expansionary fiscal policy and has been having very nearly its strongest post-war recovery. The rest of the OECD area has been following strongly restrictive fiscal policies and has been having by far its weakest post-war recovery.

DIVERGENT FICAL POLICIES: 1981 - 1984

Percent of GNP

FISCAL IMPULSE

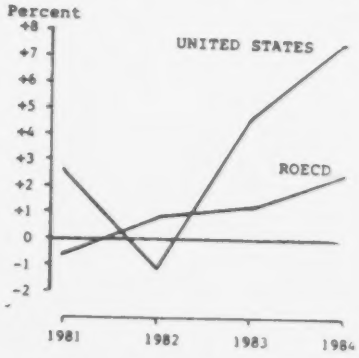
Cumulative change in structural budget deficit from 1980



Percent

DOMESTIC DEMAND

Changes from previous year



ROECD = The rest of the OECD area (the figures in the top panel are for the six largest OECD countries other than the United States.)

Source: OECD Economic Outlook, No. 35, June 1984

Why have these countries been following such apparently perverse policies? Basically because they have been particularly concerned about the medium-term consequences of fiscal actions. They have felt that because of the high level to which their structural budget deficits had risen over the 1970's, there was a real danger that once the recovery got underway, the desired rise in private investment would be crowded out by public borrowing. In this they were undoubtedly right. But in the view of some observers[4], including myself, they probably got their sums wrong, and have been trying to reduce their budget deficits too fast, before the recovery had had time to set off a strong rise in private investment. Other things being equal, these countries had hoped that cutting structural budget deficits would lower interest rates by enough to provide a positive stimulus to economic activity sufficient to more than offset the negative income effects of higher taxes and cuts in public expenditure. This might possibly have been the case, although most empirical work suggests that, at least over the first two or three years, the negative income effects tend to dominate.[5]

But as it turned out this experiment was never put to a proper test because other things were not equal. Structural budget deficits have been sharply reduced, and in Germany and the United Kingdom have moved into surplus.[6] And it is true that real interest rates have fallen from their 1981 peaks, and are now generally lower than in the United States. But in most countries they remain abnormally high given the depth of the 1980-82 recession and the anemic nature of the recovery. The

reason is that, because of the financial importance of the United States, the high level of American interest rates has tended to hold up the whole structure of interest rates in the OECD area.[7]

The result has been that the recovery in these countries has been held back both by their own restrictive fiscal policies, and by the high interest rates generated in the United States by the combination of an expansionary fiscal policy and non-accomodating monetary policy. Taken together, these two negative factors have only been partially offset by the stimulus other countries have been getting from the rapid rise in United States' imports.

It is important to realize that this peculiar constellation of macro policies in America and elsewhere has tended to produce mutually self-reinforcing trends which are helping to perpetuate the over-valuation of the dollar. The following are only three examples out of many of how this has been working. First, the weakness of the recovery in Europe, at a time of very high unemployment, has strengthened union demands for a work sharing. This led to a damaging strike in Germany (and, in a somewhat different context in the United Kingdom) which tended to undermine confidence in the currencies of the countries concerned. Second, and more generally, the relative weakness of investment demand in the rest of the world has increased the relative attractiveness of putting money into the United States. Third, the weakness of the recovery outside the United States, together with high interest rates also helps to explain why commodity prices have risen much less than in past recoveries, and have recently actually been falling in dollar

terms. And, at the global level, the combination of high interest rates, a rather moderate recovery, and a less than normal rise in commodity prices, has added to the problems of the deeply indebted developing countries, aggravating concern about their social and political stability - and hence again increasing the attractiveness of putting money into the United States.

Consequences for the United States Economy

As of now, the consequences of this constellation of policies for the United States economy appear to be distinctly favorable. The rising trade deficit has caused job losses, but these have been much more than offset by the jobs created by the strength of the recovery. The inflow of foreign savings has meant that American living standards and investment have been able to rise quite a lot faster than the output of American workers. Between the first quarters of 1983 and 1984, for example, real expenditures in the US economy rose by as much as 9½ percent, while real GNP rose by 7½ percent. At the same time, the strength of the dollar, the surge of imports, and the below normal rise in world commodity prices have all helped to keep down the rate of inflation. It is these factors related to the United States' external economic relations which go a long way to explaining how America has been able to enjoy an almost unprecendented surge in employment and prosperity, and at the same time a low and declining rate of inflation.

If this could continue indefinitely, all would be for the best of all worlds, at least as far as America is concerned. But how long can it go on? The answer is that nobody knows - at

least with any certainty. America is now borrowing from the rest of the world at an unprecedented rate. It is, however, the richest and most powerful country in the world, and for the reasons outlined above, prospects in most of the rest of the world do not look particularly bright at the moment. So it could continue to attract savings from abroad for quite some time.

In order to try to give some answer to this question, the preliminary results of some projections for a study I am currently working on may be of some interest. Let us suppose that the US recovery does slow down to an average growth rate of 3 percent from 1985 onwards. Let us also suppose that there is a sustained growth of 3½ percent in the rest of the world economy. This would eliminate the present "growth gap" which has been an important factor behind the deterioration of the US current balance over the last two years. My calculations suggest, however, that even then, for so long as the dollar remains at its present level, the US current account deficit - and the inflow of foreign savings needed to finance it - would go on rising quite rapidly, reaching perhaps $200 billion, or around 4 percent of US GNP, by 1989. For this to be sustainable, foreigners would have to be willing to increase their net claims on the United States by something like $700 to $850 billion[8] over the six years from the beginning of 1984.

I suspect that most observers would conclude that US deficits of that magnitude could not be sustained for that long. But there is room for a wide difference of views as to when the outer limits will be reached. My own view is that they

are likely to be reached by or before the end of next year. But, given the uncertainties involved, I can quite understand the views of those who argue that under favorable but not implausible circumstances the day of reckoning could be farther off.

What should be less controversial, however, is what will happen when the outer limits are reached. At that point the United States will have to stop going further into debt. In other words, the US current account deficit will have to be reduced to zero from whatever level it has reached by then. Indeed, it may have to go into surplus for a while in order to reverse some of the damage done to the US net foreign investment position. Basically what that means is that all the beneficial aspects of the present situation will be reversed.

First, whatever the forces which lead to the elimination of the current account deficit, there will be a period during which US living standards and investments rise less fast than US output. If, for example, the current account deficit had to be reduced to zero from 3 percent of GNP, this would involve a period of, say, three years in which American expenditures would have to rise 1 percent less fast than American GNP - compared with the recent past when they have been rising 2 percent faster.

Second, it may well prove difficult to restrain the growth of domestic expenditures by enough to make room for the large increase in net exports that will be needed without overdoing it. With luck and good management, the stimulus to activity from the increase in net exports could exactly offset the slower growth of domestic demand. But the experience of most other

countries in a similar situation has not been encouraging in this respect. I have set out elsewhere some of the reasons why, in order to restore confidence in the financial markets, it could well prove necessary to adopt restrictive monetary and fiscal policies which would generate a recession.[9]

Third, the more the elimination of the current account deficit is brought about by a fall in the dollar, the more this will tend to push up the rate of inflation in this country. In other words, the actual rate of inflation will rise above domestically generated inflation, in sharp contrast to the last two years when the actual rate of inflation has been running below domestically generated inflation because of the rise in the dollar.

Fourth, the structural changes in the US economy brought about by the overvaluation of the dollar will be reversed. You may remember the rather striking figures mentioned by Governor Wallich at your last hearings. He gave an estimate that, when all the effects of the rise in the dollar have worked through, about two million jobs will have been shifted from the traded goods to the non-traded goods sector. Chairman Fauntroy picked up this point and Governor Wallich agreed that such a shift has a major regional impact and is "a terrible problem for the people to whom it happens." What is important to realize is that, since in the end the dollar will have to come down at least far enough to stop American going further into debt, many people will be forced to change their jobs again and move back into the traded goods sector in order to produce the goods needed to increase exports and substitute for imports.

What is perhaps most damaging to a country's economic structure is not so much "de-industrialization", which at a moderate pace is a general trend in our economies; it is rather successive periods of forced de-industrialization and re-industrialization generated by the kind of excessive swings in real exchange rates we have experienced since 1973. Apart from the heavy social costs, some of the processes involved are probably not fully reversible. The physical and human capital in the traded goods sector which gets destroyed or is not created when the currency is overvalued may well not be fully reconstituted when it goes down again.

As a Britton, like my colleague John Williamson who testified at your last hearings, I am particularly concerned about this aspect of the way the present international monetary system is working. In my view, these structural and dynamic costs of large swings in real exchange rates, which only become apparent over quite a long period of years, are seriously underestimated by many observers in this country.

To sum up at this point. My own view is that whatever the short term benefits to the US economy of the present internationally unbalanced and uncoordinated mix of fiscal and monetary policies, the bottom line at the end of the day, when international equilibrium has been re-established, will show that over the period as a whole the costs have exceeded the benefits. And the longer the disequilibrium persists, the higher will be the excess of costs over benefits.

The Importance of H.J. Res. 585

The importance of H.J. Res. 585 is that its three clauses are directed to precisely the three areas in which US policy needs to be changed: fiscal policy, monetary policy and exchange rate and intervention policy.

Let me deal with the last two first. The majority view at your last hearings was that neither monetary policy nor intervention in the exchange markets could make a major contribution to assuring a more reasonable and stable exchange rate for the dollar. The argument had two elements. First, sterilised intervention has little lasting impact on the exchange rate. (Another way of putting this is that if the countries from which money is flowing out simply print more money, while the countries where it is flowing in simply print less, there will be no change in the monetary conditions at either end of the kind needed to alter relative rates of return and slow down the capital flow.) Second, it is argued that if the monetary authorities did not sterilize their intervention to the extent necessary to stem the undesired capital flow, this would involve major departures from domestic monetary policies consistent with non-inflationary growth over the medium run, and would therefore be highly undesirable and quite possibly counter-productive.

As far as the specific situation now prevailing between the United States and the other major industrialized countries is concerned, I tend to agree with a good deal of this line of reasoning. But, at the same time, I would emphatically reject it as a general proposition about how a flexible exchange rate system should and could work under more normal conditions.

What is often overlooked in this country, but is very evident from experience elsewhere, is that there is a strong inverse correlation between the exchange market's perception of the strength of a government's political commitment to avoiding unecessarily large changes in its real exchange rates, and the size of the departures from domestically determined monetary targets needed to have a significant impact on the exchange rate. This has been clearly demonstrated by the experience of the European Monetary System (which deserves more attention in this country than it generally gets). The political commitment to maintain "reasonable" exchange rates within the EMS takes two forms. The first is the commitment to intervene in the exchange markets so as to keep cross-rates within relatively small margins over the relatively short run. This is backed up by provisions to provide large scale short term credits to finance these interventions. But there is a second and much more important commitment which was only made credible vis-a-vis the foreign exchange markets by acts, not words. This is the commitment that, once it becomes necessary to alter these pegged cross rates - as will be inevitable from time to time - the changes made will be mutually negotiated and limited to the amounts needed to avoid unnecessary changes in real exchange rates.

The EMS has gone through sticky patches and will no doubt go through more, so it has taken time to convince the exchange markets of the reality of this second commitment. But what is interesting is that as governments have demonstrated in practice their willingness and ability to live up to it, it has proved

possible to maintain a significant degree of stability in real exchange rates between the members of the system, without massive intervention, through relatively modest departures from domestic monetary objectives[10]. And this has been achieved despite major economic and political shocks, including a world recession, a 50 percent rise in the dollar, and the election of the first Socialist government for 45 years in France.

Again, what should be emphasized about this experience is the close relationship between the political and the more technical aspects. Within a week after the French Socialist government was elected, Chancellor Schmidt made a highly publicized visit to Paris to pledge his government's support for French efforts to remain within the EMS. Equally, when it became known in the Spring of 1983 that there was a faction within the French government arguing in favor of leaving the EMS, President Mitterand moved decisively to reaffirm the French commitment to stay in it. It is true that this required him to shift French economic policy more into line with the more conservative policies of the German government. But this would have been inevitable anyway, even if the French had left the EMS - indeed in that case the policy change would almost certainly have had in the end to be sharper and more disruptive.

In my view, therefore, the experience of the EMS suggests that if governments really <u>want</u> to achieve more stable exchange rates, and can convince the exchange markets that they do, this opens up considerable scope for the monetary authorities to coordinate their actions in such a way as to achieve this

objective. How this approach might be extended to cover the key exchange rate relationships between the dollar, the yen and the deutschemark has been spelt out at some length by Professor McKinnon in a study published last March by the Institute for International Economics[11]. I will not go into the details here, but I was encouraged to see that clause (2) of H.J. Res. 585 summarizes the two main elements of what would be needed rather well. These are: (i) that each major country should be prepared to depart from its domestic monetary objectives when its exchange rate is being pushed out of line by large scale capital flows, but, equally important, (ii) the central banks concerned should cooperate closely together to see that taken together they maintain a non-inflationary growth rate in their combined money supply.

I tend to agree, however, with those who believe it would be a risky business to try to apply these rules under present circumstances. This is because, as stressed earlier, there is currently a massive divergence between the fiscal policies being pursued by the United States and its major allies, quite unique in post-war experience. Thus, the McKinnon rules would require the Federal Reserve Board to ease its policy at a time when the markets are rightly concerned that the budget deficit will in the end be monetized and spark off a new surge of inflation. His rules would also require the monetary authorities in Europe to tighten their policies, and accept a rise in interest rates, at a time when there is widespread concern in Europe about the weakness of the recovery and the continued rise in

unemployment. In other words, unless and until clear action is taken to reverse the present divergence in fiscal policies, any coordinated move by the monetary authorities to try to bring the dollar down to a reasonable level would be very unconvincing to the markets because of the sharp conflicts it would involve between domestic and international monetary objectives.

From what has been said, it should be fairly clear what action I would like to see the Administration (and Congress) to take if H.J. Res. 585 is adopted:

(i) Concrete and convincing action should be taken to reduce the budget def_cit by $100 to $150 billion over, say, the next three years. At least $50 billion of this should become effective in FY 1985, when the conflict between public and private borrowing requirements is likely to be most acute.

(ii) Once it becomes clear that such action was really going to be taken, the United States should consult with its major allies about the implications for their fiscal policies. The American side should explain that it is aiming to eliminate its current account deficit over a period of, say, three years. It should point out that, other things being equal, this would have a significant negative impact on the economic growth of other OECD countries (equivalent to perhaps 4 percent of their GNP after allowing for multipliers). They should therefore ease up on their restrictive fiscal policies by enough to offset this negative

impact, so as to maintain an average growth rate in the OECD area as a whole over the next few years at around 3 percent. In making this case it should be noted that according to virtually all the studies made on the subject, a new debt crisis would become inevitable if the growth rate in the OECD area were to fall significantly below 3 percent over this period.[12]

(iii) Once it was clear that these changes in fiscal policies were underway, scope would open up for cooperation between the Federal Reserve Board and the other major Central Banks to ease the dollar down and at the same time prevent it over-shooting in a downwards direction. As called for in H.J Res. 585, formally withdrawing the May 4, 1981, policy of nonintervention in exchange rates would be a step in the right direction. But it would not, by itself be nearly enough. As stressed above, a crucial requirement would be to convince the markets that from now on the Government of the United States was politically committed to trying to achieve and maintain a more reasonable and stable exchange rate for the dollar.

(iv) There is no disguising the fact that, given the present Administration's views on the subject of exchange rates, this would not be easy. It would require explicit recognition of the necessity for the Federal Reserve Board to depart temporarily from its pre-established monetary targets in order to achieve greater exchange rate stability. It would also almost certainly require a willingness to see the

Treasury and the Federal Reserve Board carry out intervention in the exchange markets in cooperation with the other major Central Banks on a far larger scale than has been envisaged up to now. And, most fundamentally, it would be necessary to convince the financial markets that the Administration had been genuinely converted to the view that such policies were not only desirable, but could also be successful in achieving the desired results. In the end result, it would be evidence of this basic intellectual and psychological sea-change which would be the most important.

(v) Finally, and more as a footnote, I would like to see the Administration initiate discussions with its major allies about what should be done about the incipient signs of a "tax war" developing between them. As noted above, the main consequences of the tax changes in the ERTA appear to have been to increase America's imports of other countries' savings rather than to increase American savings. As this becomes increasingly evident it seems likely that other countries will be strongly tempted to make similar changes in their tax systems. This would make it less easy for America to attract savings from the rest of the world, and, by the same token, would push up world market interest rates still further. It would also run counter to the efforts the Europeans are making to generate more employment.[13] In a related area, it is disquieting to see signs of a chain-reaction of moves by the United States, Germany and Japan to compete for the funds of the world's tax evaders through the

abolition of witholding taxes and the issuance of bearer bonds[14].

* *

To sum up. Although time is running out, I believe that the actions outlined above - if taken with all due speed, by all the parties concerned, and with the fullest possible consultation and coordination between them - could, not only bring the dollar down to a more reasonable and stable level, but, more fundamentally, reverse the growing disequilibrium in the world economy resulting from the present uncoordinated and inconsistent economic policies, before it reaches the point at which the inevitable corrective forces make themselves felt in a disruptive way and bring the present world recovery to a halt.

It would only be honest to add that I am doubtful that these actions will be taken in time, because of the amount of political capital which the governments of the United States, Japan, Germany and the United Kingdom have invested in their present policy stance. I fear, therefore, that the necessary changes will only be made piecemeal, in an uncoordinated way under the pressure of unpleasant events. In this case they could well prove much less effective in producing the desired results than would otherwise be the case.

Footnotes

1. About two-thirds of the improvement in the public sector's savings balance come from an increase in the surplus of State and Local Governments. This surplus, excluding the operations of social insurance funds, reached record levels in 1983. From now on it is likely to decline somewhat as the result of tax cuts and expenditure increases. See Survey of Current Business, January 1984, pp 32-34.
2. To an unknown extent it is thought that the recorded figures somewhat overstate the size of the US current account deficit because some current receipts fail to get recorded. At the same time estimates of net capital flows (which should be equal and opposite to the current account) are unreliable because of substantial unrecorded transactions. Estimates of how much the recorded current deficit may overstate the deterioration in the US net foreign investment position generally lie in the range of $10 - 20 billion.
3. Financial Times, London, April 4, 1984.
4. Layard, Basevi, Blanchard, Buiter and Dornbusch, The Case for Unsustainable Growth, Centre for European Policy Studies, 1984.
5. See, for example, Barry Bosworth, Tax Incentives and Economic Growth, Brookings Institution, pp 120-129.
6. Muller and Price, Structural Budget Deficits and Fiscal Stance, Working Paper 15, OECD Economics and Statistics Department, July 1984, Paris.
7. This is discussed at more length in my article "Why Europe's Recovery is Lagging Behind," Europe, Magazine of the European Community, March/April 1984, Washington, D.C.
8. The lower figure is based on the assumption that the recorded figures will overstate the current account deficit by around $20 billion this year. See footnote 2.
9. "Crisis ahead for the dollar" Fortune, December 26, 1983.
10. See H. Ungerer, The European Monetary System: The Experience, 1979 - 82. Occasional Paper No. 19, International Monetary Fund, May 1983.
11. Ronald I. McKinnon, An International Standard for Monetary Stabilization. Institute for International Economics, March 1984.
12. See William R. Cline, International Debt and the Stability of the World Economy, Institute for International Economics, September 1983.
13. Since 1970 economic growth in Europe has been generating far fewer new jobs than in America. It is widely felt that part of the reason lies in a rise in the price of labor relative to capital. To try to correct for this consideration is being given to reducing taxes falling on labor and, in some cases, raising them on capital (investment), as exemplified by the changes introduced in the United Kingdom Budget of March 1984.
14. See "Soliciting Tax Evasion," Washington Post, August 8, 1984, p. A16 .

Senator PROXMIRE. Thank you. Thank you, Mr. Chairman.

Senator HEINZ. Gentlemen, we want to thank you for taking so much of your time today to come and share your views with us. You have challenged us, you have given us a variety of stimulating views. We will be sure to share them with the members of our subcommittee and the others in the Congress who are concerned about this issue, which is I believe a growing number.

Thank you very much.

[Whereupon, at 12:37 p.m., the hearing was adjourned.]

INTERNATIONAL COMPETITIVE EFFECTS OF THE HIGH VALUE OF THE DOLLAR

THURSDAY, JUNE 14, 1984

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,

Washington, DC.

The subcommittee met at 10:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator John Heinz (chairman of the subcommittee) presiding.

Present: Senators Heinz, Gorton, Proxmire, Dixon, and Riegle.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Today the Subcommittee on International Finance and Monetary Policy will continue its hearings on the effect of the high value of the dollar on America's trade competitiveness.

Last week we heard from Martin Feldstein, the outgoing Chairman of the President's Council of Economic Advisers, and R. T. McNamar, Deputy Secretary of the Treasury, as well as a panel of experts.

Today we are pleased to have Paul Volcker, the distinguished Chairman of the Federal Reserve Board, to testify on this important issue.

As I said last week, it could be argued that the current high value of the dollar is a reflection of the success of the current administration's economic policies. The President has achieved the economic goals he set for his administration. The private sector is reinvigorated and the domestic economy is experiencing an impressive recovery marked by noninflationary growth.

But, while many sectors have recovered, many others have not. The recovery, unfortunately, has been uneven in the distribution of benefits and I see many sectors suffering under the burden of high interest rates and an overvalued dollar. These, in turn, are directly related to the twin deficits with which our Nation is saddled—the domestic budget deficit and the international trade deficit. Both are predicted to reach ever more dubious heights this year and next with the monthly trade deficit running at sixfold greater than it was just 3 years ago.

I know that the topic of this hearing today is more than an abstract economic theory. Steelworkers in my home State of Pennsylvania find themselves out of work as their product is increasingly displaced by foreign competition enjoying the equivalent of a 25-percent subsidy from the overvalued dollar. Likewise, farmers and

high-tech executives have seen their products overseas market share increase because of the 25-percent tax in effect levied on their exports by the same overvalued currency, namely ours.

The value of the dollar makes a very real difference to the competitiveness of U.S. products. Moreover, as former Assistant Secretary of the Treasury Fred Bergsten pointed out last week, if the dollar stays high very much longer there is a very real danger that major firms will begin to locate offshore to get out from under the dollar burden.

There is also a very real danger that even our most competitive firms will begin to experience permanent market loss. Profits and investment in research and development are likely to be early casualties with plant closings and still more market loss the inevitable result of the economic handicap of an overvalued currency.

Unless we act quickly to bring the dollar into line with the underlying competitiveness of the U.S. economy, there is a very real chance that a perverse trend of deindustrialization will begin to reverse the superb record of job creation which this Nation has enjoyed since 1970.

Last week we also heard testimony concerning the huge net inflow of capital into the United States which has accompanied our trade deficit. Incredibly, if current trends continue, the United States will become a debtor nation for the first time since World War I, wiping out the beneficial effects of 65 years of overseas investment in just 3 short years.

In fact, since this trend is difficult to reverse, even with remedial actions, some argue that we could find ourselves with debt/export ratios similar to those of Brazil and Mexico just a few more years down the road.

Indeed, our overvalued dollar and the resultant trade deficit is in effect turning us into a nation of debt junkies. Last week, Chairman Feldstein agreed with me that the economic withdrawal symptoms of breaking our foreign capital addiction are likely to be severe and painful, and a wrenching credit crunch and a surge of inflation as the outward symptoms.

I am eager to hear Chairman Volcker's analysis of the problem and his reaction to some of the dire predictions made last week. I can think of no more critical problem for him to address, but before I ask Chairman Volcker to proceed with his testimony I'd like to call on the ranking member of our subcommittee, Bill Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Chairman, as you say, this is the second day of hearings held by our Subcommittee on International Finance and Monetary Policy on the causes and effects of what many call our overpriced dollar. The high value of the dollar in relation to the currencies of our major trading partners has been cited as a major cause of America's fast growing and alarming merchandise trade deficit. That trade deficit rose from $27 billion in 1981 to $36 billion in 1982, to more than $60 billion last year, and is expected to exceed $100 billion this year and next year. In fact, next year, the projec-

tion is about $130 billion. Since 1981 the exchange value of the dollar has increased about 40 percent against a weighted average of the currencies of our major trading partners. Such an exchange rate change is equivalent to foreign countries simply cutting their prices 40 percent and increasing ours 40 percent. Of course, the result is exactly what you would expect. It causes our exports to decline. It also causes our imports to increase as foreign goods become cheaper in our own country, so our manufacturers lose domestic markets to foreign industry as well.

The loss of exports and increase in imports caused by our overpriced dollar means that millions of Americans are losing their jobs for reasons over which they have little personal control or even understanding. Our companies are losing out to foreign competition even when they are well managed and workers are disciplined and hard working.

A question we have been trying to answer in these hearings is why our dollar is overpriced. Last week, Dr. Martin Feldstein, the Chairman of the Council of Economic Advisers, told us that the value of the dollar was high because foreigners sell their own currencies to buy dollars to take advantage of higher interest rates in this country. He also said, and I quote from his testimony,

> The primary reason for the very high real return on dollar assets has been the increase in the deficit in the Federal budget. That deficit absorbs substantial savings and inevitably raises real interest rates.

Dr. Feldstein noted as well that,

> Last year borrowing by the Federal Government absorbed three-quarters of the private savings generated in the United States.

When the Government is borrowing that much of our savings, what is left for our businessmen and farmers, or home and auto purchasers? Very little. This Government-fueled demand for money means that interest rates have to go up, and they are.

In order to keep interest rates from going through the roof, we find ourselves importing more and more savings from abroad. Last year we had a capital inflow of $38 billion and this year that will go up to $80 or $90 billion. This pushes up the value of the dollar and gives us the growing trade deficits I mentioned earlier.

Now, Mr. Chairman, let me point out that these deficits have all the allure for those of us who run for public office that the seductive Circe had for Ulysses. What a siren call. Think of it. We run smashing deficits. What do they do for us? Well, in the long run they spell plenty of trouble. But in the short run—and all politics are short run—we are never more than 2 years from a national election—in the short run, those deficits are manna from heaven. First they hand us the big enchilada, a mammoth increase in jobs. The huge increase in deficit spending with the deficit soaring from $56 billion in 1981 to $109 billion in 1982 and to $195 billion in 1983 began to bite in November 1982. Since then we have had the most massive increase in jobs in this country in memory, a colossal 5½ million additional jobs in less than 2 years. But how about inflation? The deficit takes care of that, too. Former Assistant Secretary Fred Bergsten told this subcommittee the other day that the inflation rate would be 60 percent higher than it is now without the influx of foreign goods thanks to the lower exchange rate gen-

erated by these same deficits. Of course, all this happy, high living is temporary. As we correct the deficits as we must, the increase in jobs will fade away like the smoke from the Volcker cigars but the aroma won't linger on. And as the dollar drops in strength, imports will rise in price, and then there comes inflation. For the time being living in paradise is great. But it's a fool's paradise.

Our massive importation of foreign capital not only adversely affects our ability to trade, but it is also eroding the overseas investments we have built up over the last 60 years. We are rapidly becoming a long-term debtor to the rest of the world, the Argentina of the Northern Hemisphere. That means future generations will experience a reduced standard of living as we have to give up more and more of our own production to pay off this foreign debt.

I am delighted that we have such a distinguished witness as Dr. Volcker with us today. Just 11 months ago, he told us that we could reduce interest rates by dealing with our massive budget deficits. Congress and the President have not really fashioned a program to do that, so our economic and trade situations worsen. I do, however, look forward to hearing Dr. Volcker's views and recommendations on these issues so important to all of us. I am convinced that hearings such as this will help educate our people as to the real causes of our economic difficulties and will eventually lead us to take some remedies.

Senator HEINZ. I thank the Senator from Wisconsin. I am moved by his purple prose to observe that if T.S. Elliot, the poet, can become a hit musical, there is great hope on the stage for taking the prose of the Senator from Wisconsin and turning it into an even more dramatic event.

Senator PROXMIRE. We need the Volcker cigar as a prop.

Senator HEINZ. Senator Dixon.

Senator DIXON. I have no opening statement, Mr. Chairman. I vote for Senator Proxmire's. I'm delighted to have Chairman Volcker here.

Senator HEINZ. I'd say to my friend from Illinois, I'm glad I didn't have to follow him.

Chairman Volcker, please proceed. We are delighted to have you.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Perhaps I should announce my own long-range plans, Mr. Chairman. I am going to stop smoking cigars when the deficit goes away.

Senator HEINZ. In other words, we subsidize your habit.

Mr. VOLCKER. I have the feeling that my testimony has already been summarized in somewhat more colorful words than we use at the Federal Reserve, but let me proceed to read most of it anyway.

[The complete statement follows:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

I am pleased to have this opportunity to discuss, as you requested, the dollar, the international debt situation, and our growing international trade deficits, in the light of our budgetary deficit.

In approaching these issues, I believe it is right to emphasize, first, that the past year and more has been one of vigorous economic advance in the United States. That in turn has been a powerful force assisting growth in other industrialized countries and easing the difficult adjustment problems of much of the developing world. At the same time, that progress has been accompanied by some obvious and serious imbalances in the international economy and financial system. Those international strains are a reflection, in considerable part, of problems in internal policy here and abroad.

One aspect of those problems that has received a great deal of attention, internationally as well as domestically, is the high level of interest rates in the United States. Those interest rates have risen over recent months under the pressure of rising private credit demands, as the economy has grown, superimposed on the need to finance an already huge federal deficit. High interest rates have helped attract a growing inflow of capital from abroad, and that inflow has, for the time being, helped to reconcile rising investment with the need to finance the deficit.

But that capital inflow is not without heavy cost to us and to others in the short and long run. The essential counterpart of a net capital inflow is a massive trade and current account deficit partly

related to an appreciating dollar. Increases in our interest rates directly add to the strain on the external payments of heavily indebted developing countries. And, over time, the capital flows and trade imbalance will not be sustainable, posing the risk of further financial disturbances in the absence of needed policy adjustments.

If we are to restore better balance in our international trade accounts and relieve the pressures on our internationally exposed industries, and if we are to mitigate the burdens that high interest rates place on borrowing countries without undermining other objectives -- including stability and growth at home -- we cannot, in my judgment, escape the need for decisive action to reduce our federal budget deficit. The more slowly we proceed in correcting our internal imbalance, the greater are the risks not only to our international trade position, but also to the health of our domestic economy and our financial markets.

Congress is in the process of taking a first step toward dealing with the problem over time, and I welcome that effort. Reducing a substantial budget deficit, in the United States as elsewhere, is not easy. Popular support for painful adjustment is particularly difficult to win when the consequences of inaction are prospective rather than immediate. That, to many, has appeared to be the case over the past year and a half as our economy has performed remarkably well. From the fourth quarter of 1982 through the first quarter of this year, our gross national product has expanded at an average annual rate of 6-3/4 percent in real terms, while the unemployment rate has declined from its 10-3/4 percent peak at the end of 1982 to 7-1/2 percent in May. Moreover, the recovery has brought

healthy rates of investment in producers' durable equipment, in nonresidential structures, and in housing.

Of course, these gains started from a low level, and for a time it could be argued that an expansionary thrust from the budget deficit could be helpful. But, as the forward momentum of the economy continues and private spending and borrowing increase, the consequences of the continuing structural budget deficit are apparent.

That is perhaps most apparent in the deterioration of our trade position. One counterpart to the continuing federal budget deficit at a time of growing economic activity has been the growing net inflow of capital from abroad and its counterpart, the widening deficit in our current account transactions with other countries. In essence, that growing deficit has permitted us to consume, to invest, and to buy "more government" than provided by the increase in national output -- the GNP. In fact, all domestic demands have expanded since the fourth quarter of 1982 at an annual rate of 8-3/4 percent, about 2 percentage points faster than our gross national product. Looking at the financial side of the equation, the net inflow of capital that we have attracted from abroad is supplementing internal savings by about one-quarter -- or by more than 2 percent of the GNP -- enabling us to finance our large federal deficit while private spending on consumption and investment goods has also been growing rapidly.

Whatever the net benefits and difficulties of this process to date -- and both have been present -- the issue for the future is how to promote a sustainable pattern that meets our interests in stable and

sustained growth at home in a context of growing world trade and financial stability. In analyzing these prospects, it is useful to review developments with respect to our external position since the fourth quarter of 1980, when the dollar began its extraordinary appreciation. From that period through the first quarter of this year, our trade balance has deteriorated by roughly $75 billion, despite a sizable reduction of about $25 billion in our imports of oil. The adverse swing in the non-oil trade balance has thus amounted to about $100 billion. To put that figure in perspective, the additional $100 billion annual sales that our tradable goods industries might have retained or captured in the absence of shifts in our non-oil trade flows is two-thirds the size of the entire annual output of our residential building sector, which measures around $150 billion in the GNP accounts.

Plainly, the deterioration in our trade position has had profound effects spread through many firms and farms in all parts of the United States. Those engaged in foreign trade or competing with imports have not shared proportionately in the strong expansion of the U.S. economy, and some important industries are still operating well below 1980 levels. Exports of all major categories of goods have declined since the fourth quarter of 1980. Measured in real terms or at constant base-period prices, exports of agricultural goods declined by 4 percent on balance, while exports of nonagricultural goods declined about 15 percent. Among the leading categories of nonagricultural goods, exports of both machinery and industrial supplies declined nearly 20 percent. The longer our exports remain depressed, the more difficult it becomes to maintain marketing

networks, and the more costly and difficult it becomes to recover foreign sales.

The strong expansion of aggregate demand in the United States relative to aggregate demand in foreign industrial economies has contributed importantly to the widening of our trade deficit. In that sense, some of the deterioration in our trade position is cyclical and reflects not the loss of markets at home or abroad, but rather the absence of proportionate gains. In addition, exports have dropped sharply to developing countries that are burdened with large external debts and are in the process of readjusting their economies and their balance of payments positions. This is particularly true with respect to our neighbors in Latin America; our exports to that area have dropped by $15 billion since the fourth quarter of 1980. Together, the change in our cyclical position relative to foreign industrial countries and the decline in our exports to debt-burdened developing countries appear to explain one-third to one-half of the adverse swing in our non-oil trade balance.

The dramatic appreciation of the dollar has also had an important effect. Since the fourth quarter of 1980 the value of the dollar has appreciated about 45 percent on average against the currencies of foreign industrial countries. Over the same period, U.S. price performance has been somewhat better than the average in foreign industrial economies, but even allowing for the differential in inflation, the dollar has appreciated substantially. No doubt that appreciation of the dollar has helped to maintain the progress made against inflation during a period of vigorous recovery. But, if it proves inconsistent with a more sustainable trade

position, we cannot count on the current strength of the dollar to persist indefinitely.

The dramatic appreciation of the dollar reflects a number of forces, and the outlook for the dollar is difficult to predict. Apart from the relatively high level of interest rates in the United States, the performance of our economy and a sense of confidence in our political stability have helped encourage capital inflows, particularly when tensions have increased abroad. The degree to which these forces will continue in the months and years ahead cannot, of course, be assessed with certainty, but the point is often made that, in a purchasing power sense, the dollar is now "overvalued." Such calculations are necessarily imprecise. They differ depending upon the particular type of price index that is used -- consumer prices, producer prices, export prices, etc. -- and upon the time period that is chosen as the base period for the calculations.

There can be no doubt, however, that the dollar has risen in recent years substantially more than in proportion to movements in relative price levels here and abroad. Thus, the value of the dollar is substantially higher today than would be warranted solely on the basis of changes in the relative levels of U.S. and foreign price indexes.

But exchange rates are clearly influenced -- in the short and even in the longer run -- by factors other than relative rates of general price inflation. This often is the case when there has been a substantial change in the relative levels of interest rates, as has been the case between the United States and its trading partners in recent years. In principle, large capital inflows could persist for some time ahead even

though the United States is now becoming a net debtor internationally. But there is a serious question as to whether the situation is in our best interest or that of other countries. High interest rates pose severe problems for important sectors of the domestic economy and certainly for the indebted countries. Moreover the sustainability of our trade deficits and net capital inflows over a prolonged period are questionable, to say the least.

A precipitous large decline in the dollar, whatever its immediate cause, would not be in our interest. If related to a reduced willingness to invest in, or lend to, the United States, the burden of financing the budget deficit, in competition with private needs for credit, would be increased. Domestic prices and costs would be affected. And, the prospects for achieving lower interest rates would be further clouded.

All of that emphasizes the key importance of maintaining confidence in our economic policies and outlook. There are implications for monetary policy because that confidence must be rooted in a sense of conviction that inflation will remain under control. And there are clear consequences for fiscal policy as well because of understandable concerns that excessive fiscal stimulus may regenerate inflationary forces or stronger financial market pressures, or both.

There is a straightforward and constructive way to deal with concerns of the kind -- a way fully consistent with purely domestic needs. I am thinking, of course, of credible action to put the structural budget deficit on a course that is headed toward balance within a reasonable time period. Apart from the direct benefits of taking pressures off financial markets and reversing recent increases in interest rates, we would become

less dependent on inflows of capital from abroad to balance our savings with our investment needs. Over time, the dollar should move into an equilibrium consistent with a stronger, and sustainable, trade position. And, the risk of disturbingly large declines in the dollar should be ameliorated because U.S. policies would earn the continued respect and confidence of the financial community.

While I will not try to suggest an appropriate "equilibrium" value of the dollar over time, I do believe that balance will be struck at a higher level, and the risks of sharp and abrupt changes reduced, to the extent that we can build upon the progress against inflation. I also believe it is not in our interest to see abnormal, and ultimately temporary, strength in the dollar when such strength is really a reflection of imbalances in our domestic policies and markets.

Sometimes it is suggested that intervention in exchange markets can be useful to smooth these fluctuations, or as some would suggest now, to depress the dollar in the interests of our trade position.

In my judgment, exchange market intervention can play a useful role in dealing with disturbed market conditions or, occasionally, in signaling the desires or policy intent of the financial authorities in various countries, particularly when the approach is coordinated among them. But its role is subsidiary: experience strongly suggests that intervention alone is a limited tool that cannot, itself, greatly or for long change market exchange rates unless accompanied by changes in more basic policies. In present circumstances, as I have indicated, we have come to rely on inflows of capital to finance our domestic needs. So long

as the fiscal situation is unchanged and private credit demands are high, an intervention approach that resulted directly or indirectly in curtailing that flow would risk undesirable consequences for interest rates. Those risks would be particularly great if the United States were seen to be embarking on a deliberate policy of depreciation.

Others suggest we attack our external deficits directly, either by erecting barriers to capital flows or by restricting imports. Again, such measures do not go to the root of the difficulty.

To the extent direct measures were successful in reducing the net capital inflow, real interest rates in the United States would presumably rise, other things equal, as part of the process of replacing the lost saving from abroad with an increase in private domestic saving or a reduction in private domestic investment. The burden of our budget deficit on interest-sensitive sectors of the U.S. economy would be intensified; the problem would be shifted without resolving it. That would be true quite apart from the other compelling considerations against direct controls, which would be administratively difficult and contrary to our basic interest in open markets.

Yielding to the pressures for intensified import restrictions also could only complicate our problems. Beware, in particular, of arguments suggesting that import restrictions designed to benefit one industry or another will produce more jobs for the economy as a whole. To an individual firm or industry, shutting off import competition offers immediate advantages; more generally, it is argued that each billion dollars of the trade deficit represents a billion dollars of domestic

output foregone, other things equal. Using the rule of thumb that each billion dollar's worth of domestic output requires about 25,000 workers, it is then calculated that one million jobs could be created by reducing the trade deficit by $40 billion.

The pitfalls in such reasoning should be clear at a time when the economy is already expanding strongly: a more rapid growth of output and employment than we have experienced over the past year and a half, combined with reduced capital inflows, would likely have been reflected in more pressures on financial markets at the expense of other sectors of the economy.

More generally, it should not be overlooked that the decision to protect one industry invariably imposes costs elsewhere. It is costly to other industries if foreign countries retaliate against U.S. exports, if import restrictions lead to higher dollar exchange rates than would otherwise prevail, or if costs rise. Protection typically leads also to higher prices and less choice for consumers and can be politically difficult to terminate, as exemplified by the current export restraint program on Japanese automobiles.

Still another essential reason for resisting protectionist pressures is the adverse implications of protection for the export earnings of the developing countries. We encourage those countries to take effective measures to build their productive structures over time, and we urge strong steps to adjust their economies in the short run to generate the payments due on their debts. But those processes cannot ultimately succeed if the United States and other industrial countries protect their own markets from the competitive exports of the developing countries.

Those developing countries have traditionally been an important market for our exports, and they have the potential to be much larger. That process of two-sided trade is fundamentally a healthy one -- a process that raises our own average productivity and real income over time at the same time that it promotes growth in the developing countries. In a context of growing economies, we should be able to adjust to international competition so that we can ease the process of transition for impacted workers and firms.

That, of course, is more easily said than done. It is particularly difficult to anticipate adjustment and to accept the pressures of international competition in an environment of large and fairly rapid swings in exchange rates. Moving toward a healthier process of international development and competition over time requires that we discipline our fiscal and monetary policies to provide the conditions for more stable exchange rates.

This brings me back to the central thrust of my remarks -- the need here and elsewhere to achieve better balance in our basic policies and a more sustainable pattern of external transactions.

Much has been achieved in these last few years to put the economy on a sounder footing -- too much, at too great a cost, to see it all jeopardized now. Our recovery has been proceeding rapidly, with little acceleration of inflation. But the combined credit demands of the Federal Government and the private sector have generated disturbing pressures on interest rates, on developing countries, and on exchange rates.

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In concept, we can visualize an economic expansion characterized by relatively high interest rates and by strong private consumption and a large budget deficit. That is what we are having. But it has costs -- costs reflected in huge trade deficits and net borrowing from abroad, potential problems for housing and other interest-sensitive sectors, and risks of exchange rate and financial instability.

What is at issue is the sustainability of growth here and abroad, and our prospects for further progress toward price stability. In the end, I know of no way to deal with these risks, and to provide solid assurance that we can build on the real progress of the past, other than to carry through on the efforts to deal with the federal deficit.

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NEED TO REDUCE FEDERAL BUDGET DEFICIT

Senator HEINZ. Chairman Volcker, thank you for an excellent statement.

What you have said, in sum, is that unless we get the Federal budget deficit down, we run some very great risks—international financial instability, and higher interest rates which have an effect on our economy in terms of certain housing sectors. I imagine you would agree that it would affect other capital intensive industries such as heavy industry, machine tools, the basic capital intensive industries in this country.

Mr. VOLCKER. I would put that in the present tense; that's the only modification I would make to your statement.

Senator HEINZ. I beg your pardon.

Mr. VOLCKER. I would use the present tense of the verb—we are running those risks. We are seeing evidence of this.

Senator HEINZ. I'm going to put it a little bit more in the present tense because my first question is—we are running those risks—are we not already experiencing those problems?

Mr. VOLCKER. We are experiencing them particularly in the internationally exposed sectors—among the exporters, those competing with imports, yes.

Senator HEINZ. Well, we certainly are seeing it in our trade deficit.

Mr. VOLCKER. Yes.

Senator HEINZ. Which, at last month's rate, would not be a $30 billion deficit like it was 2 years ago, or a $70 billion deficit like it was last year, but it is heading, if you extrapolate last month's numbers, not to $100 billion or $120 billion but to $150 billion.

Mr. VOLCKER. I hope not, but it's very large.

Senator HEINZ. It is enormous and most of that is a nonoil related trade deficit.

Mr. VOLCKER. Yes.

Senator HEINZ. And we are of necessity losing whatever competitive edge we've had overseas.

Mr. VOLCKER. Our oil deficit has improved.

Senator HEINZ. It has gotten better, that's right. And while that's good news on oil, it's bad news on everything else.

My question to you is this. Is there not evidence that real interest rates are at or near their all-time high?

Mr. VOLCKER. They are very high. They are unusually high. There have been relatively short episodes in the sweep of history when they have been very high, too, usually when prices are declining—if you're measuring real interest rates. They are certainly extraordinarily high; there is no doubt about it.

Senator HEINZ. And have they not been high now for a relatively extended period of time?

Mr. VOLCKER. Yes.

Senator HEINZ. Do you see any chance of those high real-interest rates moderating?

Mr. VOLCKER. Yes, but that prospect would be enormously assisted and speeded and made certain in my mind if there were action, substantial action, on the budget deficit.

Senator HEINZ. If the Congress doesn't pass the so-called downpayment on the deficit, would you say that real-interest rates are more likely to go up or go down?

Mr. VOLCKER. I think in psychological terms that would be bound to be disappointing to all those who follow this process. They would, I'm afraid, conclude that if the political momentum and the political consensus cannot even be garnered for a program that's quite forward looking and has a very modest impact in the short run—and I obviously favor this program—that is a very discouraging sign as to the capacity of the Congress and the political system to deal with the overall deficit problem. So, yes, I think it would have an adverse effect.

Senator HEINZ. Now let's assume we do pass the downpayment on the deficit but we don't do anything at all next year or the year after. We just sit there and take what's coming to us. Under those circumstances, looking down the road 2 years, would you say that notwithstanding action this year, that real-interest rates would be more likely to go up or go down or continue to stay the same? What are they most likely to do?

Mr. VOLCKER. Let me put it this way. I take it your hypothesis is that we are left with a very large structural deficit; I don't know that the structural deficit would be growing, but it wouldn't be getting any smaller under those assumptions.

Senator HEINZ. According to most analyses we would still have a deficit of a minimum of around $100 billion?

Mr. VOLCKER. Yes, I would think probably more than that, but let's say in that range or higher. You are projecting a continuing structural deficit for the indefinite future with the risk that it will build on itself because of the compounding of interest.

Senator HEINZ. Make no mistake, if we have a $180 billion deficit per year, interest on that deficit would be accumulating and becoming more and more enormous.

PRESSURE ON INTEREST RATES

Mr. VOLCKER. I think it's clear that that would be a source of continuing pressure on interest rates. Whether interest rates went up or down would depend upon what's happening in the rest of the economy.

One could hypothesize, let's say, a rather weak economy in other respects, partly because of the dislocations of the high-interest rates, and interest rates would then come down. But that's not what you want.

Senator HEINZ. What you're saying makes sense, that if we do nothing else on the deficit, we are either going to have very high-interest rates or we are not going to have any dynamism in our economy.

Mr. VOLCKER. Yes.

Senator HEINZ. Most economists say as they look at the future is that in the second half of 1985 we are headed for a recession again.

Mr. VOLCKER. I'm not going——

Senator HEINZ. And I don't know whether they have a low opinion of Congress or a high opinion of themselves.

Mr. VOLCKER. Those economists, looking 3 months ahead, much less 18 months ahead, are not noted for their accuracy in projecting turning points. But we will have higher interest rates than otherwise in any event. You will have high-interest rates in absolute terms or you will have, I suspect, an inadequately performing economy in other respects, neither of which is a happy prospect.

Senator HEINZ. Chairman Volcker, I want to come back to that later after my colleagues have had a turn, but I do want to get one other question to you at this point, which relates to how sustainable the importation of massive amounts of capital from abroad may be.

Last year we imported $38 billion of capital into the United States. We have always traditionally been a net capital exporter. This year we will be pulling capital in from elsewhere $80 billion. That's the equivalent of 40 percent of our budget deficit and I suppose in theory, as long as we can convince other people in other countries around the world that we are politically stable, that our inflation rate is very low, and that our economy is not going to fall out of bed, that maybe we can fool people for a while.

But isn't there at some point a day of reckoning where people say:

> Well, that country has a $200 billion trade deficit or $150 billion trade deficit, and anybody who continues to lend that country money is like someone lending money to Argentina or Brazil or any of these other Third World debtor nations where the only reason people are lending is because they are so deeply in hock and because they are a bank they have to lend more.

Is there any risk at all that the United States could ever get into that kind of a position if we don't set our house in order?

Mr. VOLCKER. Yes.

Senator HEINZ. There is?

Mr. VOLCKER. Now let me comment on that question. Implicit in running this kind of a "capital import program," if that's what you want to call it, is that the favorable effects we have in the current account from net interest and profit flows toward the United States evaporates over time. You compound your current account problem, just the way you compound the budget deficit problem by having to pay interest on the accumulated debt, which makes things worse.

I think the risk that you run—and it's unpredictable and depends upon all the factors that you cited and also on confidence—is that at some point people will change their mind and they say the outlook for the dollar in particular and for the United States generally is adverse, so they will abruptly stop sending money in voluntarily. Then we've got to kind of force it in by high-interest rates, low-exchange rates, or something else, because for the moment we'd be stuck, just as those countries are stuck.

There is a difference. Let me emphasize that. You referred to Mexico, Brazil——

Senator HEINZ. Argentina and Brazil.

Mr. VOLCKER. Argentina and Brazil. Those countries have indebtedness relative to their internal productive power that is all out of proportion to anything we are going to have for a long, long time. But what I'm saying is I cannot visualize today—it could eventually happen, but I cannot visualize today that the creditworthiness of

the United States would be at risk. Maybe that's dangerous to say because something else is at risk; confidence in a more general sense is at risk; the outlook for the dollar is at risk. Those things could terminate the capital inflow.

RAPID DROP IN DOLLAR WOULD BE CATASTROPHIC

Senator HEINZ. But everybody agrees that a rapid drop in the value of the dollar, notwithstanding the fact that it is overvalued and over time we would like to see it come down to a better equilibrium--but a rapid drop would be catastrophic. Would you agree?

Mr. VOLCKER. Yes. I referred to the fact that I don't think it's in our interest to see a very sudden, precipitous drop in the dollar. But let me say, even under those conditions, much would depend upon whether we were prepared for it in a fundamental way. By prepared for it, I mean we must get the budget deficit out of the way, with its demands on our capital markets and our resources, because we would love to see a better trade balance and we would, over time, like to see less capital inflow. I think, as you suggested in your opening statement, at the moment we have to have it.

Senator HEINZ. I think you make an essential point which is that the way to avoid a serious problem, whether there's a letdown or not, is to get the budget deficit down.

The whole reason for this set of hearings, frankly, is to try and convince the American people, my colleagues, anybody else downtown who cares, that we have some problems facing us with the budget deficit. Maybe a year ago as we looked at the budget deficit it was like playing Russian roulette with one bullet in the six chambers. Today, I think we're up to about three bullets in six chambers and where we will be 2 years from now I hesitate to think, but I don't think that's the game we ought to be playing.

Mr. VOLCKER. Let me make explicit something that was implicit in what you said earlier. Some questions arise from time to time about what's being "crowded out"—to use that not very good term—by the budget deficit. You don't have to look beyond the trade deficit to see what's being crowded out. That's not necessarily the predicted effect. Our domestic economy overall has, in a sense, withstood higher interest rates, but we have had a decline in the trade balance, if I remember the figures correctly—excluding oil, which has turned positive—of about $100 billion over the past 3 years. Just to put that in perspective, $100 billion is equivalent to two-thirds of the housing industry being crowded out.

Senator HEINZ. Well, that's a most significant statistic and I do want to come back to that, but I just want to terminate this last line of inquiry, Chairman Volcker, which is this. There have been countries since World War II, developed countries such as Great Britain and Italy and others, that have had to devalue their currency when we had the fixed exchange rates prior to 1972 or 1973. In effect, they have seen pressures develop which really forced a very substantial realignment of their currency. And in a sense, I suppose, what's happened in the last 20 or 30 years—and indeed I suppose if you had been a Frenchman in the last 2 or 3 years you would have seen a very rapid fall in the franc—and what happens to them could happen to us.

Now under those circumstances, what would be the worst kind of case that you could imagine if there was a rapid fall in the dollar? What would happen to this country? Would inflation soar? Would interest rates jump because there was no capital? What would happen?

Mr. VOLCKER. A lot would depend upon a variety of circumstances, but you referred to two specific risks. One is the inflationary risk from a sudden decline in the dollar, which leads to a sense that the external competition has taken the pressure off; you would get a big expansion in demand in those industries that are affected, and that would add to pressures on the economy internally and might raise questions about interest rate effects from that avenue.

The more devastating side would be if this were accompanied by a sharp lack of confidence and fears of inflation that fed back on the interest rate structure and impinged very sharply on various sectors of our domestic economy and on our financial system. A closely related concern is the impact that that would have on developing countries.

Senator HEINZ. Very well. Chairman Volcker, my time has expired. Senator Dixon.

Senator DIXON. Mr. Chairman, I want to thank you for coming back here again. We are continually indebted to you for your assistance and your good advice from time to time.

SO-CALLED ROSE GARDEN ACCOMMODATION

Earlier this year you suggested to us what you're saying again that we have to address these serious deficit problems if we are going to get our economic house in order and bring down interest rates. As you know, after considering a number of alternatives, the Senate has passed the so-called "Rose Garden" accommodation, a 3-year plan that impacts $144 billion, about $48 billion in taxes over that period of time, and a general freeze, excluding a permitted rise in our defense expenditures.

Some of us supported what I thought were more dramatic efforts to bring the budget in line. The Hollings freeze is one that I supported. I voted for the Kassebaum-Biden freeze, an effort by my friend from the State of Washington, Senator Gorton, who is here, that I thought was significant, one by Senator Chiles.

Now the conference committee is working on the tax bill and the budget resolution. They will conference these matters and bring them back to the respective Houses.

I'd like to ask you, because I assume that the ultimate result will be something close to that $144 billion package over 3 years, whether that satisfies you as a decent effort by the Congress to meet the kind of standards you suggested early on to this committee, and is it the kind of result that will be good news to the financial marketplace and will bring down interest rates?

Mr. VOLCKER. Let me say I would be encouraged by that action. I think it's very important. I think maybe the implications are underestimated by some people; I think it is an important step. But I have to say, too, that as the term downpayment implies, it's not

going to solve the problem in and of itself. It helps bring us in a position where the problem is more easily soluble later, if you will.

The concept is, as I understand it, that the downpayment lays the groundwork; then you follow through with further action as soon as possible.

You asked whether it met the criteria that I set out earlier. I don't think it met the criteria which I loosely gave the committee, in terms of speed and amount of action in the short run that might be expected to have a noticeable positive impact on financial markets. As you may recall, I think we talked roughly in the neighborhood of $50 billion, a $40–$50 billion deficit reduction in the next year. This program has very little reduction in the next year, but I don't want to minimize the importance of moving ahead and getting that much done.

Senator DIXON. Would you say that—and I sense from what you say is that it is your suggestion that it's going to be a responsibility of the administration, whatever administration it might be in the next ensuing year, and the Congress, however it might be composed, to revisit this entire question and to make further efforts of an even more dramatic nature to reduce the deficit and to bring our deficit into line for the future in a steady sense of reduction over a period of years?

Mr. VOLCKER. That is my view, Senator, yes.

Senator DIXON. You mentioned something, Mr. Chairman, on page 9. You said:

> Beware, in particular, of arguments suggesting that import restrictions designed to benefit one industry or another will produce more jobs for the economy as a whole.

The chairman of this subcommittee, myself, and some others represent major steel-producing States in the country. I take it that when you make that kind of statement you do not suggest that this country ought to be tolerant of dumping by other countries into this country or clear violations of international agreements?

Mr. VOLCKER. No; I think that raises another set of considerations: What are the rules for trade that are fair and competitive? I'm not referring to justified complaints about unfair competition.

Senator DIXON. In other words, if there's been a finding consistent with facts by a majority of an established body—in this case the International Trade Commission—that the dumping is taking place in a clear number of cases involving let's say 89 percent of the steel requirements of this great Nation of ours, do you think that's an appropriate thing for the Congress to look at? You're not suggesting that we ought not to respond in clear violation cases?

Mr. VOLCKER. No; I think you have to look at that kind of thing. I think there's always a question of how you respond, what kind of negotiations might proceed, and so on. That is a continuing matter of trade policy that deserves attention. In my judgment, it would be a mistake to go into protectionism. It is not a mistake to maintain reasonable rules of how the game should be played.

Senator DIXON. I appreciate that because there's a very delicate line there and some of us in the Senate are very concerned that the public understands our position, which is not one contrary to the one that you have just made very clear to this committee but

one that I sense you are supportive of, that we are interested in fair trade with other countries.

INTERNATIONALIZING THE YEN

One last question. As you know, the United States recently reached an agreement with the Japanese on a package of measures to internationalize the yen, a matter that's of great interest to my State where major exporters are concerned about the question of the value of the yen against the dollar. Some commentators seem to believe that the initial impact of the proposals will be to further weaken the yen against the dollar and only over the longer term will the package strengthen the yen and I would appreciate very much and I know the committee would your view of this agreement, both in the short and the long run.

Mr. VOLCKER. I don't have any particular view about the effects in the short run. I think that argument you set forth is maybe a little convoluted. I'm not saying it's impossible that the measures may in the short run encourage more capital outflows from Japan because they made it easier to move the capital back later. I don't know whether that's possible or not. But I would not particularly expect a dramatic impact from those actions in any short run time perspective.

Another question is whether the measures are consistent with the general longer term interest in open markets, and I think broadly they move in that direction. But the basic problem in this area, in my judgment, is more fundamental than that. We have talked a lot about the problems of U.S. policy. In Japan, you see the mirror image. Everyone is very envious of Japan's very high savings rate. It runs about 20 percent of the GNP, or more than twice ours. They are apparently having a little trouble employing all those savings at home these days, so the savings run abroad and keep the yen weaker than you would think when you look at Japan's current account position and trade position, which are in very large surplus.

This raises the question of whether Japan shouldn't be doing more to employ a larger proportion of that enormous savings capacity at home to make a contribution to better equilibrium from that direction.

Now that case is a little cloudier than ours, even though Japan runs a fairly big Government deficit. They have been trying to get it down, and it's hard to argue for bigger deficits. But their problem—a problem in quotation marks—is this enormous capacity to save when the growth of their economy and their internal investment needs have been lower than they were 10 years ago in relative proportions.

Senator DIXON. I want to thank you very much for your appearance, Mr. Chairman.

Senator HEINZ. I think, if Senator Gorton will permit me, I need to call on Senator Proxmire and then Senator Gorton.

Senator GORTON. I would certainly defer to my colleague.

Senator PROXMIRE. I would be happy to have Senator Gorton go ahead if you're in a hurry.

Senator GORTON. I need to be gone by 20 minutes to 12.

Senator PROXMIRE. Why don't you go ahead?

Senator GORTON. Thank you very much, Senator Proxmire. I appreciate your courtesy.

Senator Dixon went right at what seemed to me to be the heart of the information which I hope to elicit from you. I'd like to follow up on it a little bit.

If my memory serves me correctly, earlier this year in speaking eloquently for fiscal discipline on the part of the Congress, you stated that if we could not only come up with a downpayment on this budget deficit but that if it could be substantially front-end loaded on the order of about $50 billion for fiscal year 1985, we might actually see a drop in interest rates of perhaps a couple of points.

My memory of the precise date on which you made that statement is a little bit hazy, but I think it was before the increases in the prime rate or at least before most of them took place.

You have also, in response to Senator Dixon, said that you feel that even the downpayment which is before a number of conference committees at the present time is significant and may in some quarters be overlooked.

PARAMETER OF DOWNPAYMENT GOALS

A week or so ago, when this same subcommittee heard from Martin Feldstein, he went beyond what we are doing at the present time in response to a question by me in estimating the second- and third-year benefits of the current downpayment as being on the order of $50–$70 billion, and stated that his view is that the next payment, the payment we are going to have to make to keep current, would have to be on the order of doubling each of those figures for fiscal year 1986 and 1987.

I'd like to ask you whether you agree with that or what parameter you would set out for what next year's goals should be, No. 1; and No. 2, do you think the current downpayment, if it is actually adopted by conference committees by both Houses and signed by the President, will at least be sufficient to arrest the current alarming increase in interest rates until we have a chance to come back here next year and do the job again?

Mr. VOLCKER. Let me just make one preliminary comment. You referred to these rough statements made about the deficit and interest rates. I just want to have the record show that what I have consistently talked about is an impact on interest rates of about 1 percent lower than they would otherwise be at this point in time.

Senator GORTON. I stand corrected.

Mr. VOLCKER. I hesitate to try to give you any numbers. On the last question, about the impact of the current program, I think it is an important action in making the problem more manageable for the future. On the other hand, you have to recognize there's nothing in that program in the short run, in the period of time upon which the market immediately focuses, the next 12 months or so. In terms of affecting credit demands in the next 6, or the next 9, or the next 12 months, there's nothing there. Credit demands are running high already, as you know.

What effect you have is in an expectational sense; it's very hard to tell what you have already had. I think that it's fairly clear that if Congress backed away from that program that it would be taken adversely in an expectational sense. But, given by its structure the absence of important short-run impacts and the fact that it's known you have been working on it for some time, I don't think you can expect any magical effects in the short run.

I don't have precise estimates in mind as to the degree to which you will have to follow it up in numbers. I think it would be confusing if I tried to throw out numbers off the top of my head. My impression is that, even with that program, assuming that there's no backtracking in the next 2 years—and at the edge there's necessarily some haziness about just what the estimates mean 2 years ahead—and assuming it's in the neighborhood of $50 billion plus when you get out a couple of years, my impression is you're still left with a structural deficit on the order of over $100 billion. There's nothing magic about achieving precise balance in a particular period of time, but this does give you some sense of the extent of the job that remains to be done not in any single year, but over the period of time ahead.

Senator GORTON. Thank you. You spoke in the very last part of those comments about the structural budget deficit. I assume that when you use that term you mean the portion of the deficit which would remain even if we had a full employment economy.

Mr. VOLCKER. Yes.

FULL EMPLOYMENT OVERVIEW

Senator GORTON. Which, of course, implies some sense of what full employment is. In your view, how close are we to full employment now and what unemployment rate corresponds with the term, as you understand it?

Mr. VOLCKER. There are two aspects to capacity. One is capacity in the sense of how much plant, equipment, and so forth you have around; the other is the labor side. There's a question of whether they're fully in sync: in other words, when you have what you think is full employment in terms of labor, whether you have the plant and equipment ready to deal with that efficiently and without inflation.

When I use that kind of estimate for the structural budget deficit, I'm taking a rather conventional view that something like a 6-percent unemployment rate—in that general area—represents a reasonable measure of full employment for present purposes. That's the way we've done it for a good many years.

If you look at it in plant capacity terms, we are very close now to the average for the postwar period; obviously in boom periods it's been higher. If you look at individual industries you see signs of much lower margins of excess capacity. You see so far a very limited number of industries that are at practical capacity, and one of the problems is, given this interest rate structure, whether we will build additional capacity fast enough where it will be needed to meet the needs, assuming, let's say, full employment on the labor side.

Senator GORTON. On another subject, your statement repeatedly refers to a net capital inflow into the United States over the course of the last 3 years. Last week we heard testimony that this net inflow was not the result of faster inflows of capital into the United States. Rather, the net inflow, according to this testimony, was the result of a reduced outflow because of such factors as reduced bank lending to Latin America and to Eastern Europe.

Is this a valid distinction, and if it is, is it important?

Mr. VOLCKER. I think there's certainly been reduced outflows, and I think the banking system has brought in some increased inflows in the gross sense. In the analytic sense that I'm using this, I don't think there's much distinction. The question is, on a net basis, how much ends up in the United States, and net, it's a big inflow.

Senator GORTON. If the dollar were to depreciate by say roughly 10 percent against other major currencies during the balance of this year, what effect would that have on the domestic inflation rate and would the Fed take any steps to counteract that?

Mr. VOLCKER. That depends on what else is happening. I don't think it's necessary to take direct steps to counter that kind of partial reversal of the appreciation of last year, but our actions would be judged in the total context of economic activity—rate of growth, rate of credit growth, money supply growth——

Senator GORTON. You can't isolate that?

Mr. VOLCKER. You can't isolate that factor. In terms of its inflationary effect, if you take a rather mechanical approach to it—punch the buttons on the computer and see what it tells you—you see that over a period of time, maybe over a period of 3 years or so, you would expect, on the average a cumulative effect in the area of 1 to 2 percent on prices over that period of time. I think all of those things have to be put in the context of a particular situation at a particular time—how much capacity is available here, how much capacity is available abroad. The exchange rate is one factor, and it's not an unimportant factor. If goods remain readily available from abroad, the American market remains highly profitable, for a while you may get lesser effects. In other circumstances, you might get greater effects. It depends upon how much productive capacity there is to pick up in the United States in the short run.

Senator GORTON. Thank you. Thank you, Mr. Chairman, and I particularly thank you, Senator Proxmire.

Senator HEINZ. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Chairman Volcker, I have known you for a long time and I apologize for calling you doctor. I understand you haven't completed your doctorate yet.

Mr. VOLCKER. That's right. I'm still working on that thesis.

Senator PROXMIRE. Well, it's just as well. I read something the other day about a man who died and they had on his tombstone, "He was born in 1902 and died in 1982, published but perished anyway." [Laughter.]

Mr. Chairman, last week Mr. McNamar, the Deputy Secretary of the Treasury, refused to admit a connection between budget deficits, interest rates, and misaligned exchange rates. He said:

Thus, we are told that the dollar has been driven up unnecessarily by an excessive U.S. budget deficit and high U.S. interest rates.

He went on to say,

In response, I would point out that whatever connection one believes there may be between the budget deficits and interest rates—and the evidence on that issue is uncertain at best—empirically, there's been very little correlation between interest rates and the exchange rates.

Now in contrast, in your prepared testimony to us, you say,

If we are to restore a better balance in our international trade accounts and relieve the pressures on our internationally exposed industries, and if we are to mitigate the burdens that high interest rates place on borrowing countries without undermining other objectives, we cannot, in my judgment, escape the need for decisive action to reduce our Federal budget deficit.

I take it, then, that you disagree with Mr. McNamar, who represents the administration's position on these issues; is that right?

Mr. VOLCKER. It appears that way.

Senator PROXMIRE. It appears that way? Do you disagree with the administration?

Mr. VOLCKER. Well, if they are saying—I don't want to get in an argument with somebody who isn't here.

Senator PROXMIRE. Why not? [Laughter.]

Mr. VOLCKER. I will let my statement stand on its own bottom, so to speak.

Senator PROXMIRE. That's the only kind of argument I get into. [Laughter.]

Mr. Chairman, there are not many economists who support the administration in its consistent contention that U.S. budget deficits have nothing to do with high-interest rates and the high value of the dollar.

Could the administration, knowing that high-interest rates are on the way, be setting you and the Fed up to be the scapegoats for such high-interest rates?

Mr. VOLCKER. You're in an area of speculation that I have no knowledge of and——

Senator PROXMIRE. It certainly is a possibility, isn't it?

Mr. VOLCKER. I wouldn't speculate on that. I don't see why.

Senator PROXMIRE. You wouldn't be stunned if that were the case, however, I'm sure. Well, that's an uncomfortable question. Let me get on with this.

DOLLAR VALUE DROP RATIO TO INFLATION

Last week, Dr. Bergsten pointed out that our huge trade deficits, which cannot be maintained, do help hold down inflation in this country. He said if the dollar did drop in value by 20 percent, it would mean that inflation would jump by 3 percentage points. He maintained that for every 10 percentage points move of the dollar exchange rate the Consumer Price Index moves about 1.5 points in the other direction. I haven't heard any economist make that argument before and if it's true it seems to me it's a very interesting argument.

Mr. VOLCKER. That's the same range that I gave Senator Gorton. That is the cumulative impact over a period of time; it doesn't raise the inflation rate by that amount.

Senator PROXMIRE. Well, how long a period of time?

Mr. VOLCKER. Most of these equations would suggest that order of magnitude, say, over a 3-year period; that is the cumulative impact over that period of time.

Senator PROXMIRE. Last week Mr. McNamar was asked what did he think about suggestions made by some that interest rates on loans to debtor nations be capped so that as U.S. interest rates rise those countries don't get increasingly squeezed in their ability to pay off their debt. Mr. McNamar said, "A few dilettantes and people have made that suggestion. I've never seen anyone who has really thought about this problem propose this idea."

I'm not asking if you're a dilettante or haven't thought about it, but have you and Dr. Solomon of the New York Fed advocated looking at the possibility of a cap on interest rates on loans to Third World countries?

Mr. VOLCKER. I have thought about it a bit, however you characterize it.

Senator PROXMIRE. Can you tell us what you think of that concept?

Mr. VOLCKER. What I've said and what I believe is that this is one of several ideas that others have raised as a financing technique. It's nothing very fundamental; it is a financing technique that might usefully be explored. Whether it's useful or not in the end depends upon whether the borrowers or lenders, in reaching a voluntary decision, think it's mutually beneficial.

Senator PROXMIRE. But an effective cap, wouldn't that mean that the free market would tend to dissuade the banks from making loans if they had to make them with lower rates of interest?

Mr. VOLCKER. I use this word "cap," which is subject to misinterpretation on variable rate mortgages now. It's a very common domestic financing instrument. Back in the days when I came into the banking business, and for a good time thereafter, it was very common to make term loan arrangements, for instance, that might have a fluctuating rate related to prime but that said "no more than this," or "no less than that." Those all fall into this general, generic concept of caps. It's been a widely used financing instrument in the past in various circumstances and is in some areas currently used.

Senator PROXMIRE. When Dr. Feldstein testified before the Finance Committee in March, he discussed the long-run impact of recent capital inflows into this country. He noted, for example, "In the future, the United States will have to give up some of each future year's GNP to our creditors abroad to pay for today's excess of imports over exports."

MASSIVE TRADE DEFICITS WILL CAUSE LOWER STANDARD OF LIVING

Dr. Bergsten agreed that today's massive trade deficits would cause Americans to have a lower standard of living in the future.

Do you agree and can you tell us why or why not?

Mr. VOLCKER. Yes. I think that that is true as a broad matter of economic analysis, but looking at things in a very long-term equilibrium sense. You borrow a lot and you've got to pay the interest, and while you can keep borrowing to pay the interest for a while,

you just defer the day when you have got to pay or people will stop lending to you. Yes, that's true.

You have to look at it in terms of the magnitudes involved, relative to the size of the economy and all the rest. But, of course, these developing countries—or some of them—have this problem now in spades; they did a lot of net borrowing and the net borrowing may go up less in the future or not at all for a period of time, but they have to pay the interest, which comes out of their domestic income.

Senator PROXMIRE. Now we had another difference between McNamar and Bergsten and perhaps you can help us on this. Last week Mr. McNamar referred to a recent agreement with the Japanese on the yen/dollar issue. He said, "The long-run result should be a significant strengthening of the yen." Bergsten said that that recent agreement would make the yen even weaker in the short run by encouraging more capital outflow from Japan. Even in the long run he did not believe it would greatly strengthen the yen.

Who is right on that?

Mr. VOLCKER. I think Senator Dixon raised that short-run point earlier. As I said, I think it must depend upon some thought that there is more freedom to move capital in and out of Japan. In the short run, given the imbalance in savings in Japan and the imbalance in savings in the United States, the argument is that the measures might encourage more outflow in the short run because the markets work more smoothly. I don't want to associate myself with that view; I don't know whether that would be the case at all. You would tend to think, if the measures had any impact, it would go more in the other direction. How much impact the agreement has in the long run I think is in question. I think it will make the markets more open, more fluid. It does accord with the general concept that international markets should be more open, and that, to some degree, corresponds and supports the openness of trade. Whether it turns out to be a large, independent factor on exchange rates in the long run is related to the extent that controls have been effective in the past—controls may not be quite the right word. I think you might expect that the yen would be in equilibrium at a little higher level, which is what I believe Mr. McNamar was saying.

Senator PROXMIRE. I think that our agreement to lend Argentina $300 million with the signing of the IMF Letter of Intent expires on Friday. Do you expect that agreement to be extended?

Mr. VOLCKER. I don't think I can comment on that usefully this morning, Senator. That agreement was with the Treasury; it's their decision and I think I will let them comment on that.

Senator PROXMIRE. Are the other countries—Brazil, Mexico, Colombia, Venezuela—which lent Argentina $300 million in mid-March being aggressive about being repaid?

Mr. VOLCKER. I haven't been in contact with them recently enough to answer that point definitively.

Senator PROXMIRE. Do you think Argentina will be able to meet the new round of interest payments due at the end of June or will the creditor banks have to wait?

Mr. VOLCKER. I think that depends on what happens between now and June. There's been negotiation with the banks on that

very point and certain proposals have been made and tentatively agreed to, as I understand it, that would make that feasible and probable. The question is the bearing on those agreements of recent developments concerning the so-called Letter of Intent, and the Treasury agreement, and so forth.

Senator PROXMIRE. Thank you very much, Mr. Chairman.

Senator HEINZ. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman. Most of my questions have already been asked, quite frankly.

I'd like to follow up, though, on a question that the Chairman propounded earlier.

OVERVALUATION OF THE DOLLAR

Chairman Volcker, some commentators in the financial community—I think probably all the commentators I read in the financial community—believe the dollar is currently overvalued in relation to other currencies and increasingly we run the risk of a decline of the dollar.

In your opinion, is the dollar currently overvalued in relation to other currencies?

Mr. VOLCKER. One has to be careful. The word "overvalued" is a shorthand expression. If by overvalued you mean has the dollar risen in value from some reasonable base period in the past—which is always one of the questions—has it risen more than is congruent with or justified by—changes in relative prices, the answer is yes; the dollar has risen, as I said in my statement, by something like 45 percent over the past few years. There haven't been relative price changes to justify that kind of change.

But if you ask the question in a different way, if you mean is this sustainable in some sense, then you have to include the interest rate question. You have to tell me what's going to happen to interest rates here and abroad and what's going to happen to the budget deficit here and abroad. People might have asked that question 1 year or 18 months ago. What happened since then? The dollar has appreciated some more.

Senator SASSER. Well, really the question I'm coming around to, Mr. Chairman, is: What is the risk to our economy if we get a dollar suddenly declining in value on the world market or even a suddenly collapsing dollar? What is the risk?

Mr. VOLCKER. I think the risks would be substantial if we're not prepared for it, and let me say again quite frankly what I mean by being prepared for it. If we are prepared for it in the sense that we are not so dependent upon a capital inflow—and a reduced incentive to invest in the United States might be one reason for the dollar to decline—then we can absorb it within the normal dynamics of the economy reasonably well, I believe. The obvious way to prepare for it, in my judgment, is to reduce the Federal deficit so we are not dependent upon the foreign capital inflows to finance it. If that's going to be cut off—which is what you're saying, in a sense, when you ask whether the dollar will go down sharply—and we suddenly have to finance all that out of the domestic market, we've got problems. If we don't have to offset it domestically, the problems are much ameliorated. We still have an inflationary

impact, relative to everything else that's happening, but we also have got a better foreign trade position, which would be a nice thing to have. There would be pluses and minuses. There would still be problems, but there would clearly be pluses and minuses. It tends to be minus if you're not prepared for it.

Senator SASSER. With regard to trying to do something about our deficit here and we've been talking about that for years—I've been in the Senate for 8 years and I think during that period of time 6 or maybe more you have been Chairman of the Fed, and I have heard you testify about the danger of the budget deficit and we have talked about that time after time and really the administration and Congress have done a minimum amount to try to address that issue, in my judgment.

We have finally come up with this so-called "Rose Garden" downpayment which is, I suppose, the minimal amount that can be done. Now I'm a member of the Budget Conference Committee and there is an excellent chance that that Budget Conference Committee is not even going to agree on the so-called downpayment.

Now in the event this downpayment goes by the boards, then what's going to happen? What effect is this going to have, for example, on interest rates?

Mr. VOLCKER. It wouldn't change the flows of credit at all in the short run in one sense, because, as you well know, if you look at the program from a 12-month perspective, there isn't much in it. It's a more forward-looking program. In that sense, it wouldn't have an impact.

When you look at it in an expectational or psychological sense, I think you would run the great risk that it would be interpreted as a further indication of the inability of the Congress to reach a consensus on this issue.

Senator SASSER. Not inability, but unwillingness, I would say.

Mr. VOLCKER. Unwillingness; inability in a political sense. I agree with you that it's quite possible in a technical sense. If the downpayment does go by the boards, it would be taken as a discouraging signal of what might happen later. Will we ever face up to the deficits or will we simply let things deteriorate? Will we let the pressures on the market build—if they do build—without getting a coherent budgetary program together? I think it can't help but be an adverse signal in the expectational sense, although I suspect some people already expect that to happen, so it's hard to tell just how it would affect things. It's not a positive signal.

ARGENTINE DEADLINE

Senator SASSER. Shifting gears just a moment, Mr. Chairman, Argentina's current negotiating strategy with the IMF seems to raise a question if the Argentines will miss the June 30 deadline for paying the overdue interest. What would be the implications of failure on the part of Argentina to pay interest on the outstanding debt and what I'm really interested in, does this run the risk of creating turmoil in the U.S. banking system?

Mr. VOLCKER. What's at issue here is a fairly limited number of interest payments and how that fits with the technical rules for how one accounts for loans. I would not want to put that out of

perspective at all; in itself, I don't think it's terribly significant. You may recall that actions were taken almost literally at midnight in March to avoid that situation; the fact that they were taken almost literally at midnight also indicates that the banks had been quite prepared to see that happen. I don't say that they like it. You would rather see the continuity maintained, and it would be better if the continuity were maintained. But the fact is, whether those interest payments are made on that precise date is not nearly so significant as whether the Argentine Government and other governments will have an effective adjustment program, whether that will be supported by necessary rollover of existing debts, new credit to the extent needed in a little longer timeframe than June 30. What's important is the degree of progress made in those areas.

Senator SASSER. Mr. Chairman, what do you think the lesson should be from the recent problems of Continental Illinois other than not having depositors that are foreign depositors as the large ones?

Mr. VOLCKER. I wouldn't say the lesson is that you shouldn't have foreign depositors; foreign depositors act pretty much like domestic depositors. You have a very large bank and a loss of confidence essentially because of questions about its domestic loan portfolio and domestic lending practices. I think any lessons to be drawn from that situation would go to the practice of that particular institution, and what, if any, implications that may have for others about the nature of the lending process.

Senator SASSER. One final comment and I'd like to get a comment from you, Mr. Chairman, and I don't mean this to be a critical statement.

CONTINENTAL ILLINOIS CRISIS

I was in a meeting with small bankers in my State about 2 weeks ago and there was much conversation there—this was at the time of the Continental Illinois crisis. There was much conversation there that we have a free enterprise banking system with regard to small- and medium-sized banks. They have the privilege of either succeeding or failing in our economy. But large banks are not exposed to those risks and they are not allowed to fail. And these small- and medium-sized bankers were lamenting the fact that this was unfair. They felt that they had been unfairly treated and I listened to them and I wasn't quite sure what response to make.

I'd like to get some recommendations from you as to how to respond to these questions.

Mr. VOLCKER. Let me say, first of all, that the risk of failure and the risk of management changes or dispositions are there in either case. Nobody has said that stockholders of Continental Illinois Bank are guaranteed anything or that the management of Continental Illinois Bank is guaranteed anything. I should also say that in the case of small banks—and we've had more failures of small banks in the past couple of years than we've been used to—in most of those cases——

Senator SASSER. We've had a lot of them in my State.

Mr. VOLCKER. In fact, in your State, you will recall, in a bank in Nashville—certainly small in comparison to Continental Illinois; I think around $250 million—the FDIC injected capital before the bank failed, and that situation was taken care of without any loss of money to depositors. I think their stockholders lost all their money and their management was out of their jobs, but, in a sense, it was a very analogous situation to Continental at that stage. I'm not saying that Continental Bank is going to fail, but at that stage the injection of capital by the FDIC into the small bank was analogous to what has been done with Continental Illinois. It's not entirely a big bank/small bank contrast.

The issue goes to the protection of the depositors, not to the question of stockholders or to the failure of the bank.

As a practical matter, in dealing with situations of this sort, we did face the fact that Continental Illinois had a sudden loss of confidence, a very large loss of depositor or other funds, and that the connections with other institutions were such that collectively—the Federal Reserve, the FDIC, and the Comptroller of the Currency—we felt the situation should be stabilized by the Government support that was provided. I think I understand the kind of reaction you get from the small banks. I also think you would find that many small banks understand, from a general policy viewpoint, the necessity for that action and sympathize with it.

I also think that it does raise questions that need to be dealt with over a period of time, not on an emergency basis, about the nature of deposit insurance, how it is administered, the brokered funds questions that you're familiar with. Brokered deposits weren't an issue with Continental Illinois, but it does permeate questions about how the deposit insurance system in fact affects incentives and behavior and what changes should be made, with great care, over a period of time.

Senator SASSER. Can you comment on Mr. Isaac's proposal that we have different rates for Federal deposit insurance based on the risk that the FDIC would be taking in insuring various depositors?

Mr. VOLCKER. In my mind, that's one of the questions that arises in connection with a very careful and orderly examination of the whole question. I have had some doubts in my own mind as to whether that particular approach is as promising as some others.

Senator SASSER. Thank you, Mr. Chairman.

Senator HEINZ. Senator Riegle.

Senator RIEGLE. First of all, let me commend you, Mr. Chairman, for calling these hearings and I appreciate the chance to be able to ask questions, although I'm not normally a member of the subcommittee.

Mr. Chairman, first of all, I think your presentation today is an important one to the committee and I think it goes beyond other presentations that we've had on the nature of this set of problems that we are dealing with. I appreciate the fact that it does go further than other presentations that we have had.

UNITED STATES BECOMING A NET DEBTOR

You mentioned in two places here, on page 4, you say, "Plainly, the deterioration in our trade position has had profound effects

spread through many firms and farms in all parts of the United States." Then later on, on page 7, you say the United States is now becoming a net debtor internationally. Certainly that's a new condition for us in recent times.

Then you go on further to say on page 7, "Moreover, the sustainability of our trade deficits and net capital inflows over a prolonged period are questionable, to say the least."

When I put together these kinds of comments, I say to myself that if these trends continue—you talk about how we might change them—but if they were to continue and we were to stay in the posture of being a net debtor internationally and we were to stay in a posture where our trade deficits stayed at these levels or even worsened, what are the kinds of economic consequences that would be down the road for us if we failed to change these trend lines?

Mr. VOLCKER. The mere fact of being a net debtor internationally is interesting as a symbol of the degree of deterioration there's been, but I don't think that, in itself, being a limited net debtor internationally for a country as big and strong as the United States presents any crisis. It's kind of an anomaly for the biggest and richest country to be dependent on the rest of the world for credit. It's not helpful, but it's not a crisis kind of thing.

What is damaging is implicit in the suggestion that it's not sustainable. If it's not sustainable, it's not sustainable over time politically as well as economically. You have an important sector of the economy—namely, the international sector, which includes farms—scattered all over. The danger is of unconstructive, to say the least, political pressures and responses. It would be greatly damaging if this forced us into a highly protectionist posture, for instance.

The other danger is that its unsustainability subjects you to the risk of rather abrupt changes of mood and behavior that would be damaging—damaging to the financial markets, damaging to inflation, damaging to confidence, if you are not prepared for them and they are not handled smoothly. That gets back to the question of whether, right now, we are rather too dependent upon those capital inflows. We've got to get ourselves in the position where we are not dependent on them so that a smooth or a reasonably orderly transition can be made to a position that is sustainable.

Senator RIEGLE. Doesn't that mean that we are in a position of risk in the sense that as long as we stay in this current posture?

Mr. VOLCKER. Yes, I think that is the message.

Senator RIEGLE. Now I don't know if anybody has written a scholarly piece that's definitive on what it means if our merchandise trade deficit is running at an annual rate in the range of $130 billion plus, which based on last month's numbers is about where it is. Some people have said that maybe that doesn't matter if you have that kind of a net loss of merchandise trade deficit if on the other hand you have credit money coming back in being loaned to you by foreigners. These, to me, are two quite different transactions.

In the one instance you've got in a sense equity money in your own country and you're buying all those goods internally, but if you're buying them externally that money leaves the country and it comes back in the form of a loan. That's quite a different kind of

thing. That just appears in a different spot on the balance sheet than if it's in a sense national equity money.

Mr. VOLCKER. And that means a different structure of industry.

Senator RIEGLE. It means a lot more than that, doesn't it? You mentioned one thing, for example, if people decide that they don't want to loan us money any more.

Mr. VOLCKER. You can look at it from the capital side. If you run that kind of a trade deficit year after year, that means you are importing large amounts of capital year after year. If the trade deficit remained at $120 billion or wherever you want to put it, then the surplus in other current account items, mainly interest and profits, will disappear over time because the debt is getting bigger and bigger, and the need for capital flow will compound upon itself. I'm just taking off from your assumption that the trade surplus remains exactly the same. You not only have to draw $80 billion this year, but next year more foreign capital and the following year more foreign capital. I think that suggests the unsustainability of the process. At some point people don't want to lend that much. It also suggests a point that someone else made about which I said, "Yes, that's a long-term implication; it doesn't concern me at the moment, but eventually it would concern me." That is, you've got to pay that interest and our output has to be shifted abroad more and more to pay the interest.

Senator RIEGLE. If that happened and less foreign money was available to us and we were still in an expansion phase or strong phase in our own economy, wouldn't that likely drive up domestic interest rates?

Mr. VOLCKER. You make a lot of assumptions. If you're in a strong expansion phase in the domestic economy, if the budget deficit remains high, if domestic credit demands are high and there is suddenly a reluctance for capital to come in from abroad, I think the question answers itself.

Senator RIEGLE. And that answer is rates would probably go higher?

Mr. VOLCKER. Under that particular set of conditions. You can have other conditions where that won't be the case.

MOMENTUM OF THE ECONOMY

Senator RIEGLE. Let me just quickly jump to two other things. In terms of the momentum of the economy at the moment and everybody is watching that carefully and there's data that's produced each day on it—the car sales and other things. Are aggregate credit demands in the United States likely to turn down any time soon, as you assess the momentum of the economy at the moment?

Mr. VOLCKER. I think that depends upon the momentum of the economy as a first approximation. If the economy continues to advance but at an appreciably lower rate of speed and a sustainable rate of speed, I think you would expect the rate of credit demands to decline.

Senator RIEGLE. Do you see any of that happening?

Mr. VOLCKER. I think that's quite——

Senator RIEGLE. Can you see signs that that's happening now?

Mr. VOLCKER. I think you see some signs. I think it's hard to tell just how far they go and I don't want to make a precise forecast beyond saying I think that would be a rather normal and natural expectation at this point in the cycle and given an evaluation of everything else that's going on.

I also point out that a lot of this expansion and strength has been underestimated in the past.

Senator RIEGLE. Just on that point, when one assumes in the interest rate sensitive sectors like autos and housing, when rates continue to climb as they have and it's very obvious with the VA mortgage rates and so forth, that you see some fallout in that activity. On the other hand, there are an awful lot of businesses outside of those sectors that have made their bets. They are out doing things. They are in the middle of some kind of a project or some kind of an activity, and it isn't necessarily possible for a lot of them to suddenly just stop or draw back. In other words, you just sort of rolled the dice and made your investment decisions and you have to go ahead. I'm just wondering——

Mr. VOLCKER. Nor is it in anybody's interest to have the economy abruptly change course either.

Senator RIEGLE. Exactly. But I have tried to check myself whether I see any kind of significantly lessening of credit demand in the economy now in the aggregate, and I have a hard time identifying it. I gather you say you see some of this.

Mr. VOLCKER. I don't know so much about the credit demands right at the moment and, of course, all these statistics lag. I think you can certainly see some signs that the economy is not growing at the rate of speed that it grew in the first quarter. You pointed out some sectors that appear to be leveling off or could even decline somewhat.

On the other hand, business investment, as you point out, is going up, and going up quite strongly, but even that sector was going up at a very fast rate in the fourth quarter and in the first quarter; and consistent with even the buoyant expectations—the Economist survey the other day—you would have a slower rate of growth in business investment than we've had in the past 6 months. You wouldn't expect that housing advance to be repeated. You say there are statistics this morning on the automobile industry. I haven't seen them. That's been at a much higher level recently, but there's no particular expectation that it's going to take another quantum leap up. On the other hand, inventories may be moving in the other direction, but inventories tend to be a fairly short-term phenomenon. Once you stock the inventories, you don't keep doing so forever, and there has been a fair amount of inventory building that tends to be related to credit demands in the past 3 or 4 months. That doesn't necessarily persist forever.

Again, I'm not trying to make a forecast, but I certainly understand the expectations of many people that the most likely outcome as the year progresses would be a slower rate of economic advance than what we've had. I will make that much of a forecast. I think the question is how much slower; and that will come back and affect the credit demand and interest rates, of course.

LEVERAGE BUYOUTS

Senator RIEGLE. Just very briefly one final thing on a different subject. I saw in today's papers that you have expressed concern about the risks involved in the leverage buyouts and have also indicated that large loans by banks to support mergers may have restricted credit for other purposes or caused an increase in interest rates. I'm wondering if you could just comment briefly on your concern regarding leverage buyouts and then address the question of how mergers and acquisitions like this affect the availability of credit and conceivably impact interest rates.

Mr. VOLCKER. The question that arises in the leverage buyout area in my opinion—I speak now as a bank regulator and supervisor—is whether all the risk potential down the road of that kind of financing is fully appreciated in making the loan in the first place. The leveraged buyout is what it says it is; it is lending, often against assets to a company that has a relatively thin layer of equity. That raises flags, I suppose, right off the bat. Are the risks being fully appreciated when the credit is made? Is the credit being extended in a sufficiently restrained way or is this a fad, with some of the risks being minimized? I would hope that the banks are looking at the risks with great care when they take on these commitments, which typically extend over some period of time. I think it's very important that they be carefully and conservatively evaluated.

With regard to the credit aspects of mergers, I might say that one concern I would have about mergers in the very general sense it's not about the mergers per se but about what other people say is an antitrust issue and so forth—is the extent they reduce the amount of equity in the economy as a whole. I like to see a good layer of equity in the economy. Some of them do not affect this—an exchange of stock, for example—but if you're borrowing money and if in particular you're borrowing a large amount of short term to pay off the stockholders in another company, there's less equity in the economy and more debt, and I don't think that's a terribly healthy thing.

In the long run, that should all get balanced out—the stock prices should be higher and so forth—but it tends to work in the wrong direction in terms of the total financial picture in the economy.

In terms of its effect on interest rates, I think if there is any, it's probably a pretty transient thing, because this money does flow back in the markets. The seller gets the money and presumably doesn't go out and spend it all or any of it really. He goes and puts it back in the market in some form, so you have kind of a wash.

There may be some impact, because the financing tends to be done by banks, for a time on the credit market; therefore, banks may be a little more filled up with loans than they otherwise would be for a period of time. But even then, you find with some of these big financings that are initially done in whole or in part by the banking system that in a matter of weeks or months they tend to get refinanced, and at that point a large share of the financing is done outside the banking system through longer term debt, commercial paper, or otherwise.

Senator RIEGLE. My time is up.

Senator PROXMIRE. Mr. Chairman, the hour is late and I just have one other question I'd like to ask, and I appreciate your willingness to remain and answer questions during this long hearing.

There's been concern expressed by some that Argentine officials are relying on the Federal Reserve to rescue our banks from the consequences of an Argentine default. They say the Federal Reserve prevented the failure of Continental Illinois and, as a result, Argentina has become more intransigent in its negotiations with the banks and the IMF.

Have you noticed such a fallout from the Continental rescue package?

Mr. VOLCKER. Not in terms of motivations for Argentina. We, of course, have our basic responsibility in the original Federal Reserve Act, which is to act as part of a safety net and support system for the commercial banking system. We have no intention of permitting the commercial banking system to become a hostage in these kinds of issues.

Senator PROXMIRE. But isn't the consequence of this, if a bank takes on loans from a country which may refuse to pay interest on time, refuse to pay back the principal, that the Argentines and other countries know that, just as you told us, the Federal Reserve isn't going to permit a big bank to fail and therefore they don't have the discipline that they might have otherwise?

Mr. VOLCKER. I didn't quite phrase it that way. The stockholders have problems if that happens. Other people have problems. But I would think, from Argentina's standpoint, that they've got to worry about the impacts on Argentina. I would think that's where their motivation and concern should lie.

Senator PROXMIRE. Thank you.

Senator HEINZ. Chairman Volcker, as I understand it, there are about $600 billion of very liquid assets held by foreigners, approximately $190 billion of which is in very short-term Government securities, and roughly $450 million is in relatively liquid market assets, stocks, bonds, and private paper.

Therefore, it's possible that if people ever got discouraged about the dollar, that a lot of this capital, under perhaps extraordinary circumstances, but a lot of that capital could move out of this country fairly quickly. Is that not, under some circumstances that we dearly don't want and we don't predict, but is that not a possibility?

Mr. VOLCKER. To put it technically, they can try to move out, but under the conditions that you are postulating, they may not have any buyers. What that means, however, is that I don't see this happening.

INTEGRITY OF THE DOLLAR

Senator HEINZ. If there are no buyers for the dollar, what does that mean?

Mr. VOLCKER. It means the dollar goes down.

Senator HEINZ. To what point?

Mr. VOLCKER. We've got a lot of claims out there, too. I was given a table with the figures you were just using. I just want to cite the

fact that the claims on the other side are also $600 billion, public and private. In fact, claims are greater——

Senator HEINZ. Are the claims that we have, though, as liquid and short term?

Mr. VOLCKER. No, they are not all marshallable. A lot of them are in private hands. I accept the point that you are making.

Senator HEINZ. Which is that if people got discouraged by the dollar, we could get hurt in quite a hurry?

Mr. VOLCKER. The point you are making is that you'd better maintain confidence in our outlook and our policies, and I fully agree with that. That's true of any country. If I could just relate this to Argentina for a moment, or any of these borrowing countries, they have suffered from capital flight. In one way, the central test of their policies isn't whether the IMF at a particular point in time approves a particular letter, or whether the banks at some point in time advance a little more money. The question is whether they are maintaining the confidence of their own citizens. We can talk about the $600 billion figure. Well, Americans probably own a couple trillion dollars of liquid assets and you could ask what happens if Americans all want to go into some other currency?

Senator HEINZ. We tend to assume that Americans have a little bit more staying power where this country is concerned, but that may just be wishful thinking on my part.

Mr. VOLCKER. I think they are all affected at the margin by the same set of circumstances and, in the end, it comes down to a matter of confidence. You've got confidence in the policies, you've got confidence in the productiveness of the United States, you've got confidence in the outlook, you've got confidence in the political system. All this money has been flowing in, in part, because there is that confidence and we want to keep it; I think it's terribly important that we keep it. The one operating lesson I draw is that those people who think the Federal Reserve has the option to turn on the money faucets and deal with this problem that way have to ask whether turning on the money faucets is conducive to maintaining confidence.

Senator HEINZ. Well, that's really the question I was going to ask. We are told that there are two ways of maintaining confidence. One is just to keep doing what you're doing, Congress, everything is working fine. Fiscal policy has been on a steady course for the last 3 years, don't change fiscal policy. Otherwise, you will call into question confidence in our economic policies.

Now, of course, our current fiscal policy is a $180 billion a year deficit if the downpayment on the budget deficit is enacted. It's a $200 billion plus deficit and rising if we don't have a downpayment on the deficit. The other alternative, which is the one you favor, is to cut the budget deficit, get serious about it and do whatever is necessary.

I guess the third alternative is what the Federal Reserve, as the custodian of the Nation's money supply, would do if we didn't follow alternative 2 and we followed alternative 1 and then all the bad things we've talked about today took place. You would be put in the position of having to monetize the debt in order to keep interest rates from soaring or allowing them to soar and allowing the country to take the consequences.

Would that not be the two basic choices you would have if we did not reduce the deficit?

Mr. VOLCKER. You put this in very extreme terms.

Senator HEINZ. Well, I mean to, because I think that if we don't deal with the issue, we're going to be faced with some extreme situations, all of them bad.

Mr. VOLCKER. We are going to conduct our policy in a way that is consistent with maintaining the confidence that you speak of. We are going to work toward dealing with inflation. We've made a lot of progress in that direction and I hope we continue to do so, and we want to do that consistent with a growing economy.

What you were saying, and I agree with, is that that job becomes more difficult and there are more risks if the deficits persist at the current level. At the same time, just looking at it in a short-term perspective, the way you posed the question almost seems to suggest we—not just the Federal Reserve, the country—are in an absolutely impossible position at the moment.

As I was discussing with Senator Riegle a while ago, one could well envision a tendency over the coming months for a slower rate of private credit expansion, accompanied by a healthy but appreciably slower rate of business advance—a so-called soft landing, to use that cliche—consistent with improvement in the interest rate situation; that's one scenario.

I do agree with you that the risks of much less satisfactory scenarios increase under this budgetary situation. You talk about fiscal policy. There have been improvements made in the tax system in recent years. The deficit is one critically important aspect. How you deal with that deficit is not unimportant. Certainly, it is, in my mind, the key problem. The evidence, in terms of the various risks and possibilities out there in the future, seems to me to point very clearly to that action as the prudent and really the only way of making an important improvement in economic policy. We cannot solve our problem by monetary policy. And, we have to operate within the constraint of maintaining, again, a basic confidence about the outlook with respect to inflation and the economy generally.

REAL RISKS TO ECONOMY

Senator HEINZ. Well, of course, in order for people to understand the risks that you talk about on page 12 of your statement and elsewhere, we have to understand what those scenarios of risks are, what those events we may confront, which we don't want to confront in particular, but what they are all about and how bad they can be for the country.

The problem that the Congress is having—and I suppose I should include the administration—is that, first, no one wants to think that the bloom could ever come off the rose, that there's ever going to be any problem down the road. Second, everybody rather likes the fact that we in the last 2 months created 1 million more jobs in this country and that makes us all feel pretty good.

Third, it's an election year and nobody wants to make any more tough choices than are necessary as the political stakes in a Presidential year get pretty darned high.

Fourth, it's human nature to procrastinate.

Well, if you add all of those up, you can see why Slade Gorton and others are having some difficulty even getting the downpayment on the deficit done in the budget conference. If we don't tell the American people what the real stakes are, if we continue to say, well, maybe down the road there is a risk of this or that and we don't want to spell out what those risks are, we will be having this hearing next year or the year after and we will be saying, "Why do we have the present economic crisis we have? Why didn't somebody warn us?" And I certainly don't want to be a part of any complacency that would suggest that we might be suffering from that situation now.

Let me ask one other kind of question. Since people do basically relate much better to what's happening now—as opposed to something awful that might happen a few years from now—is there anything disturbing to you happening to this country as a result of the strong dollar, the trade deficits, the high real-interest rates, that is of substantial consequence and which, if there is a trend involved here that is allowed to continue is quite serious? If so, what are these things?

Mr. VOLCKER. It seems to me quite clear that there are things that are going on that are very serious at the moment. In a way it's strange—if I may say so—that you asked me the question, because I get letters or calls from Congressmen about this all the time. The trade problem which is felt by industries in your State and in other States is massive. As I described it in its totality, it's equal to two-thirds of the whole housing industry. I hear about that all the time. The only question is whether the response is adequate. I don't think the appropriate response is a protectionist one.

Senator HEINZ. On that point, what is the long-term consequence of that so-called problem? The obvious immediate consequence is on unemployment in the steel industry, depending on when we're talking about and in the auto industry, certainly in machine tools and other basic industries, but what's the long-term consequence?

Mr. VOLCKER. You're hitting me both ways. I talked about the long term and you say it's not pressing enough. I talked about the short term and——

Senator HEINZ. If the short-term consequence of a trend is unemployment, what is the long-term implication?

Mr. VOLCKER. It's a weakened competitive position for some very basic industries in the United States, a change in the basic structure.

Senator HEINZ. Which is another term, you might say, for deindustrialization?

Mr. VOLCKER. All right, deindustrialization.

Senator HEINZ. Do you think that high interest rates, the strong dollar, the budget deficit, is an important, if not even the primary force, in bringing about currently a deindustrialization of America?

Mr. VOLCKER. Well——

Senator HEINZ. A simple yes or no is all we require.

Mr. VOLCKER. In the context in which you are using the word, probably yes. I don't want to suggest that industry in the United States is going to disappear, but there is a lot of it that is going to

change anyway. There are obviously going to have to be changes in the steel industry and other industries.

Senator HEINZ. But apart from the normal structural changes?

Mr. VOLCKER. With a deeply distorted pattern, I think that is the risk; that is not only the risk, that is what would happen.

Senator HEINZ. But apart from the normal change one would expect, would you say there's an overlay of deindustrialization accelerated by or propelled by this?

Mr. VOLCKER. There is certainly a degree of it, yes.

Senator HEINZ. Does it also affect high-tech industries? Are high-tech industries being hurt here?

Mr. VOLCKER. I think much less so now, but they eventually would be hurt, too. They, of course, benefit enormously from the innovation in the economy and the sense of innovation here can change. The climate in that area is apparently extremely favorable, but you would expect to see that advantage eventually transfer abroad. In that area, we have not seen it in the same direct way. We have enormous spontaneity and growth in that area. That's where the growth in investment is, and it's a good area in which to have it. I think there's a longrun threat, but it's not nearly so severe at the moment.

I don't want to stay on only the trade problems. We've got strains out there in the agricultural community from interest rates. We have the strains on the developing countries and their massive debts, which feed right into the issues in the United States, financial and otherwise. We lost $15 billion worth of exports to Latin America over the past couple of years as a reflection of those problems. They are aggravated by the interest rate question. The housing industry is doing fine so far with the help of a lot of innovative financing techniques. How long that can continue is a question under these circumstances. There's a lot of evidence of the distortions, the strains, the problems right now. They are there for many to see.

Senator HEINZ. Chairman Volcker, you have been very generous with your time. I don't know if Senator Riegle has any additional questions.

Senator RIEGLE. Just one.

Senator HEINZ. I know the Chairman needs to leave about now. By all means, if you keep it to one question. I think the Chairman would be willing to accommodate us.

Senator RIEGLE. I thank you.

I think the questions that were being developed here by Senator Heinz and by myself and others are very important questions and your willingness to come and talk about them I think is a very important step on your part.

I'm not trying to get you to say something that's going to make people more nervous than they are, or set off any kind of panic, because I don't have that desire, and obviously you're not going to do it in any case. But the question I have is this, in the context of everything that's been said.

REACHING OUTER LIMITS OF FINANCIAL CREDIT SYSTEM

I have the feeling that we are starting to press up against the outer limits of our financial credit system, not just in this country but internationally, as I look at the situation. Obviously, we've got to crank in a lot of factors like: What are the tolerable and acceptable levels of interest rates? What kind of growth pattern do we want to sustain? How do we want to hold the world economy together so it all flourishes, and not parts flourish, and the rest collapse, and so forth?

But it looks to me as if we're really starting to press against the outer limits of what we are capable of doing, partly because of the massive deficits and partly because we are in deep holes in some places where people can't get out right now. I'm thinking of the Third World debt situation and what have you.

I'm wondering if you share that sense. Do you have the feeling? Again, I want to put it in the context of how much more margin do we have? Do we continue to basically pile up these kinds of problems and difficulties or are we, in fact, now sort of getting out to the outer bounds of what any sensible or prudent manager or person would want to set as sort of the end limits of what we ought to subject ourselves to, and as the time comes to recognize that it's not just a question of philosophical arguments here but the fact that we will really start to pose some enormous dangers if we try to press out beyond what constitutes the prudent outer limits?

Mr. VOLCKER. I don't think I can give you any more of an answer than I have already given, Senator Riegle. I think, basically, we have a strong financial system, for all the signs of pressure in some isolated areas. We certainly have a strong system of defense for that financial system. Do I think it is urgent to deal with this deficit problem that leads to strains currently and prospectively? I have been saying for 1 year, yes, I think so, and time is passing. I said 6 months ago that I thought we had some time, but we don't have time forever. You can't sit here and count on markets fitting your timetable. I can only leave you to make your own judgments, the judgments you have to make. I would urge you to proceed as expeditiously as you can.

Senator RIEGLE. Thank you. Thank you, Mr. Chairman.

Senator HEINZ. Chairman Volcker, as always, we are delighted to have you here and thank you for your time and for your excellent answers. We are most appreciative.

The hearing is adjourned.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

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